Foreign exchange Rate

Q What is an open economy
An economy which shares trade relationship with other countries is termed as an open economy. In other words an economy which has a foreign sector and deals with import & export of goods and services is termed as an open economy

Q ADVANTAGES OF AN OPEN ECONOMY

In the modern open economy interaction with other economies of the world widens the choices of the people in three broad ways
(i) Consumer and firm finds the oppurtunity to choose between domestic and foreign goods. This is known as product market linkage which occurs due to international trade
(ii) Investor gets the oppurtunity to choose between domestic & foreign assets. This is known as financial market linkage
(iii) Firm can choose where to locate production and workers can choose where to work. This

is known as ~~fem~~ factor market linkage.

Q NOMINAL EXCHANGE RATE

It is the exchange rate in terms of money. ex. 1 dollar = ₹60. This ~~the~~ is the bilateral nominal exchange rate in the sense that. It is the exchange rate for one currency against another.

REAL EXCHANGE RATE

It is the ratio of foreign price to domestic prize measured in the same currency. ex-

Real exchange rate = $\frac{eP_f}{P}$

Here P_f = ~~price~~ foreign price
P = domestic price
e = Rupee price of foreign exchange

ex. If nominal exchange rate is 1\$ = ₹60 Then real exchange rate is $\Rightarrow \frac{eP_f}{P}$ (If $P = 150$, $P_f = 5\$$)

$\Rightarrow \frac{60 \times 5}{150}$

$\Rightarrow 2$

$\Rightarrow 2:1$

i) This means the goods are two times expensive than goods at home.

ii) If real exchange rate is equal to 1, it means good cost the same in two countries when measured in the same currency.

MEANING OF FOREIGN EXCHANGE

~~When~~ foreign exchange means foreign currency. All currencies except the domestic currency of a country is termed as foreign exchange.

e.g. dollar for India is a foreign exchange.

MEANING OF FOREIGN EXCHANGE RATE

The price at which one currency is exchanged for another, it is termed as foreign exchange rate. In other words, rate of exchange is the price of one currency stated in terms of another currency. e.g. if ~~one dollar~~ $1\$ = ₹50$

Then $₹1 = \$\frac{1}{50} = 0.2$ cent

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This exchange rate is the ratio of exchange between currency of two countries. It is also known as external value of the currency

EXPLAIN DEPRECIATION & APRECIATION

Depreciation of a currency implies fall in the external value of a currency. When a unit of domestic currency exchanges for lesser unit of foreign currency, then the domestic currency is said to be depreciated. It occurs due to free play of demand and supply of foreign exchange

On the other hand apreciation implies a rise in the external value of a currency. ~~When~~ a

Q How depreciation is different from devaluation?

→ Both ~~are~~ of the terms implies fall in the external value of a currency. However ~~se~~ depreciation occurs ~~when~~ automatically when there arrises an ~~imf~~ imbalance/ fluctuations between demand & supply. On the other hand devaluation ~~occ~~ is done by the government.

FUNCTIONS OF FOREIGN EXCHANGE MARKET

It is a market where nation currency are traded for one another. The major participants in the market are commercial banks, foreign exchange brokers and the monetary authority

FUNCTIONS

i) Transfer function - It helps in transferring the purchasing power in terms of foreign exchange across different countries of the world.

ii) Credit function - ~~It~~ It provides credit to importers and exporters of goods and services across different countries.

iii) Hedging function - It protects against the risk involved due to change in foreign exchange rate. Under this the importers and exporters get into an agreement in order to fix a pre determined exchange rate to carry out the transactions even if the payments are to be settled in a future date.

SPOT MARKET - In this market spot or current transactions are taken up. This market is of daily nature and all the transactions are settled within a span of three days. The exchange rate that prevails during the time of transaction is termed as spot rate of exchange.

FORWARD MARKET - It deals with future deliveries of foreign exchange. It fixes the exchange rate at which future transactions are to be honoured (3 months). The exchange rate which prevails during the time of transaction is termed as forward exchange rate. The forward contract are made for two reasons.

(i) To minimize risks of loss due to adverse change in exchange rate using hedging.

(ii) To make a profit which is called speculations.

FACTOR AFFECTING EXCHANGE RATE

i) Change in price :- Change in the price level leads to change in the exchange rate for instance, if the price level in India rises in comparison to USA. This will lead to rise in the price of Indian exportable goods and thus the export of India to U.S.A will fall. ~~and~~ Therefore, the supply of dollar in India will also fall. Similarly, the U.S goods which are the imports of India will become cheaper. This will be reflected in increase in import bill of India which will increase the demand for dollar. This situation of falling supply and increased demand of foreign exchange will set the exchange rate at a higher level.

ii) Change in export and import - If the export of a country are more than inputs, the demand for its currency increases & therefore the foreign exchange rate moves in its favour & vice versa

iii) Change in income - When income increases, the consumer spent more on imported good which inturn increase the demand for foreign exchange. This will fix the foreign exchange rate at higher level. If on the other hand, income of foreign country increases, they will demand more of our exportable commodities increasing the level of foreign exchandge supply in the country. This will fix the exchange rate at a lower level

iv) Speculations - Speculative activities also influences exchange rate, for instance, if the Indian expects that the value of dollar will go up in the near future, then they will start demanding more of dollar. This will increase the demand for foreign exchange

and shift the exchange rate
at a higher level