FOREIGN EXCHANGE RATE

class 12

TO D0-

- Foreign exchange and foreign exchange rate
- Flexible and fixed exchange rate
- Managed floating
- Components of the demand for foreign exchange rate
- Components of the supply of foreign exchange rate

Foreign Exchange & Foreign Exchange Rate

Foreign Exchange- It refers to foreign currency.

Foreign Exchange Rate- The rate at which domestic currency can be exchanged for a foreign currency.

It is the price paid in domestic currency for buying a unit of Foreign currency.

Eg- if 50 rupees are to be paid to buy 1 US dollar, the exchange rate is-

$ 1 = Rs 50

Flexible and Fixed Exchange Rate

Exchange rate is broadly classified as-

- Flexible Exchange Rate
- Fixed Exchange Rate

Flexible Exchange Rate

It is also called floating rate of exchange, it is determined by the supply-demand forces in the foreign exchange market.

Determination of Flexible Exchange Rate

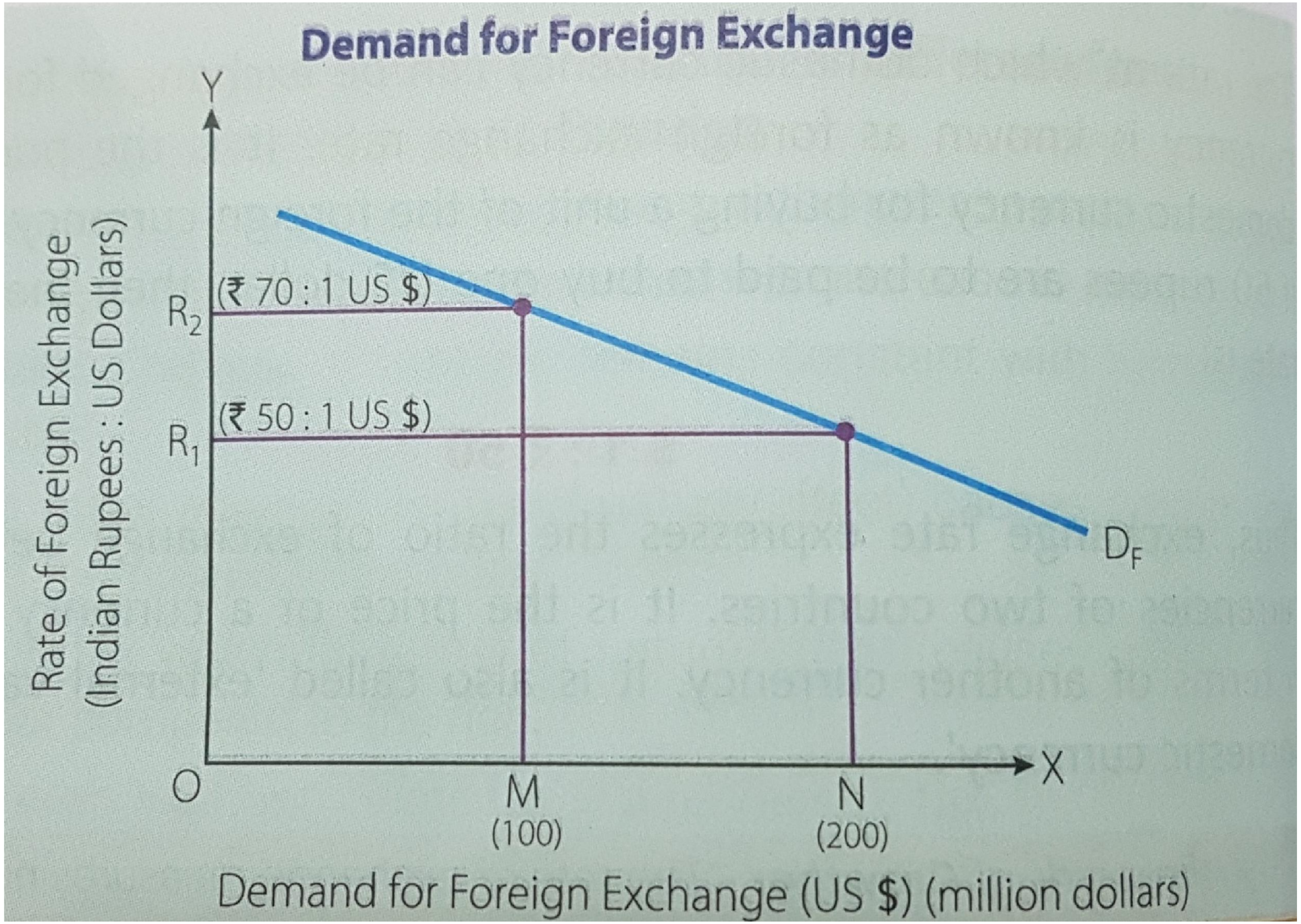
Demand for and supply of Foreign exchange are the two basic determinants of flexible exchange rate.

Demand for Foreign exchange

Other things remaining constant, demand for foreign exchange is inversely related to the price of Foreign exchange.

Thus, higher the rate of foreign Exchange, lower the demand for foreign Exchange, vice versa.

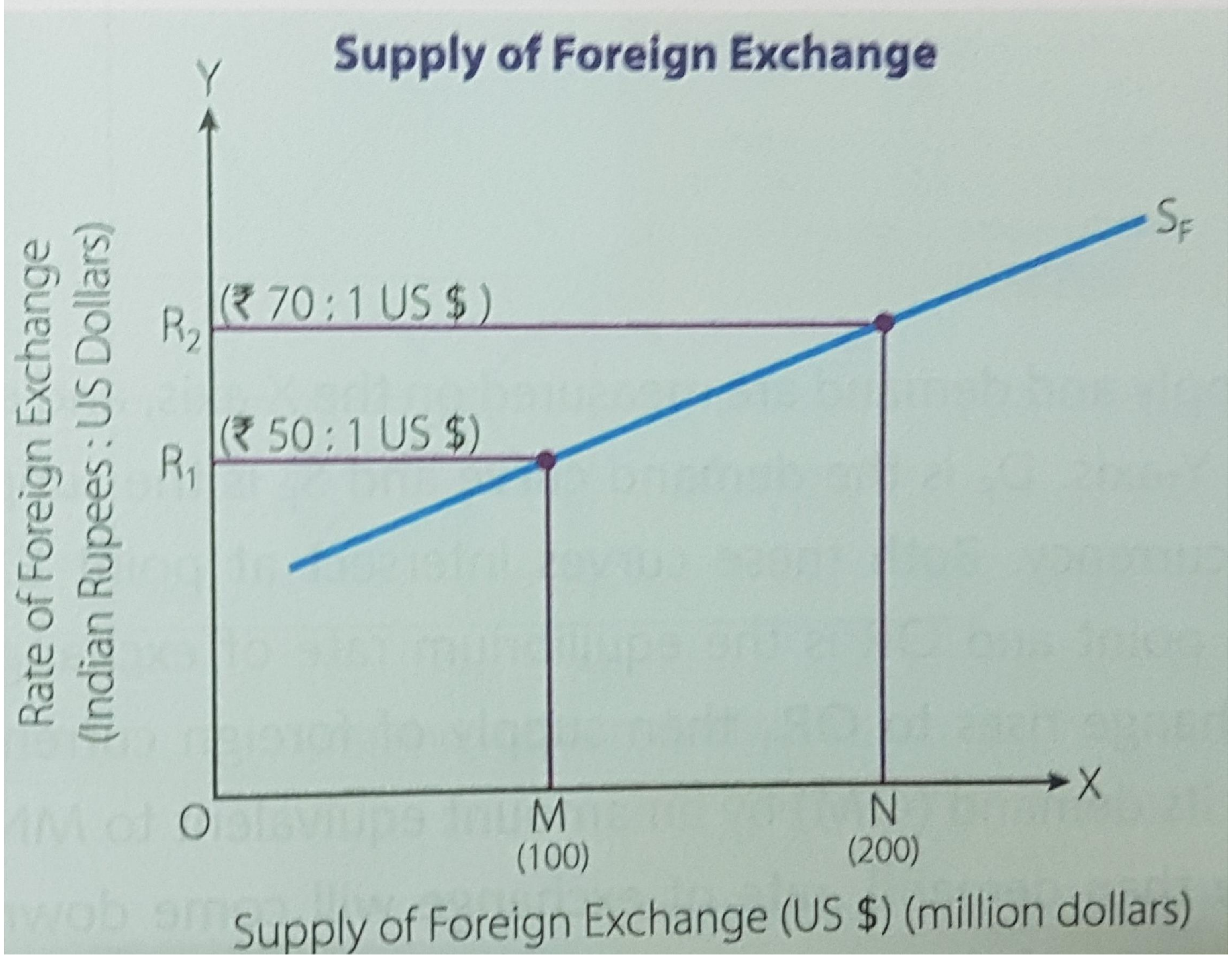
Diagrammatically, demand for foreign Exchange is indicated by a downward sloping curve in the next slide.



Demand for Foreign Exchange
Y
Rate of Foreign Exchange
(Indian Rupees : US Dollars)
R2
(₹ 70 : 1 US $)
R1
(₹ 50 : 1 US $)
DF
O
M
(100)
N
(200)
X
Demand for Foreign Exchange (US $) (million dollars)

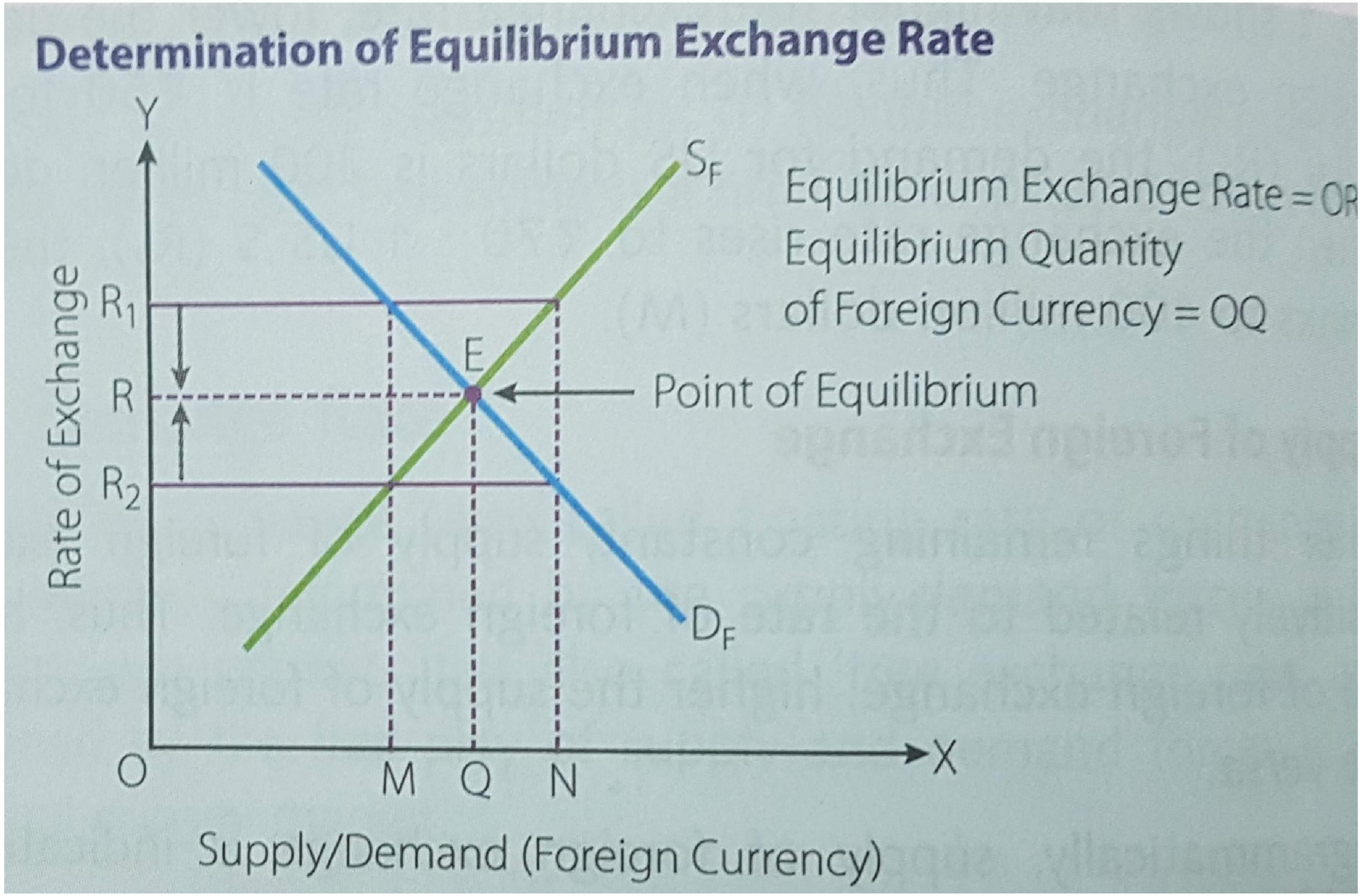
Supply of foreign Exchange

- Other things remaining constant, supply of foreign Exchange is positively related to the rate of foreign Exchange.
- Thus, higher the rate of foreign Exchange, higher the supply of foreign Exchange and vice versa.
- Diagrammatically, supply of foreign Exchange is indicated by an upward sloping curve.

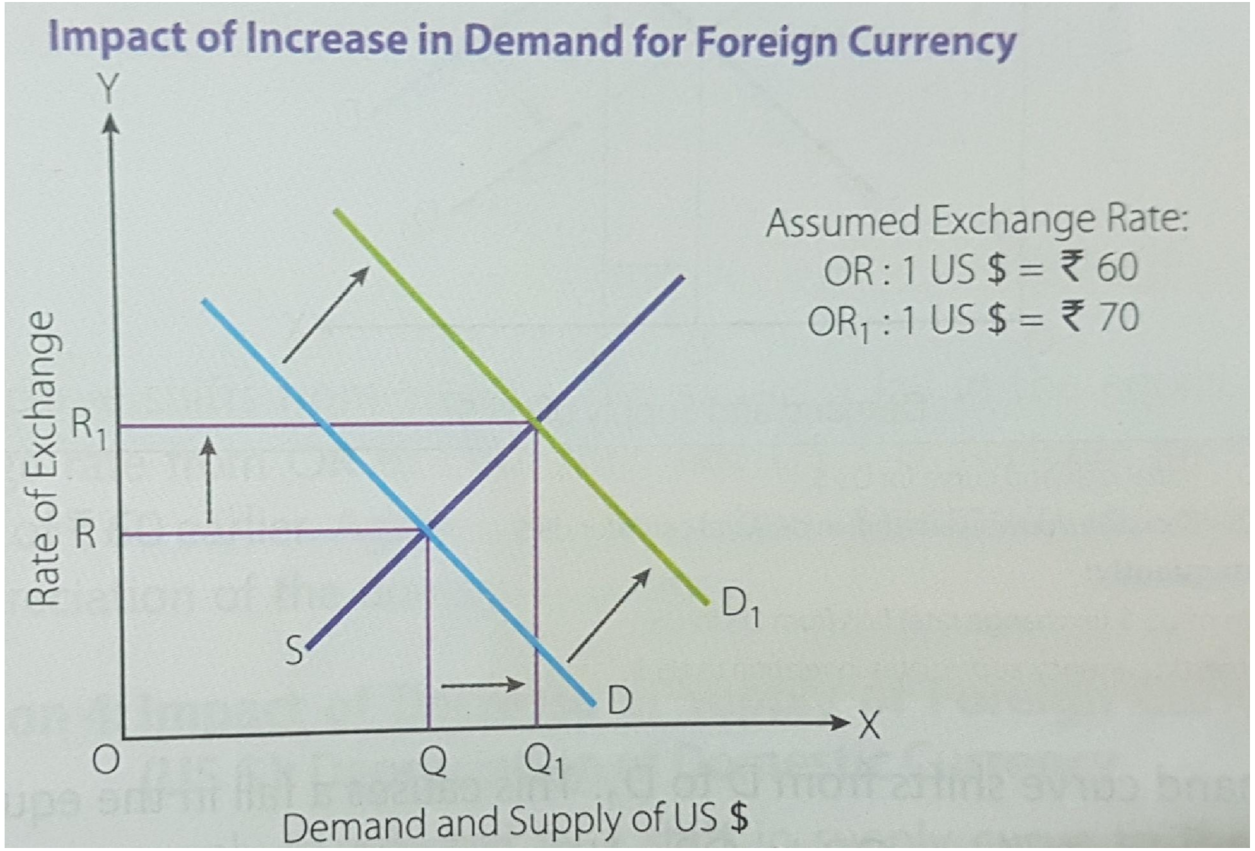

Supply of Foreign Exchange
Y
S_F
(₹ 70 : 1 US $)
R_2
(₹ 50 : 1 US $)
R_1
Rate of Foreign Exchange
(Indian Rupees : US Dollars)
X
O
M
(100)
N
(200)
Supply of Foreign Exchange (US $) (million dollars)

Equilibrium Rate of Exchange

- Equilibrium Rate of Exchange occurs when : supply of foreign exchange = demand for foreign exchange.


Determination of Equilibrium Exchange Rate
Y
Rate of Exchange
R1
R
R2
O
M
Q
N
X
E
SF
DF
Equilibrium Exchange Rate = OR
Equilibrium Quantity
of Foreign Currency = OQ
Point of Equilibrium
Supply/Demand (Foreign Currency)

Impact on increase in demand for foreign currency(US $): Depreciation of domestic currency

- 

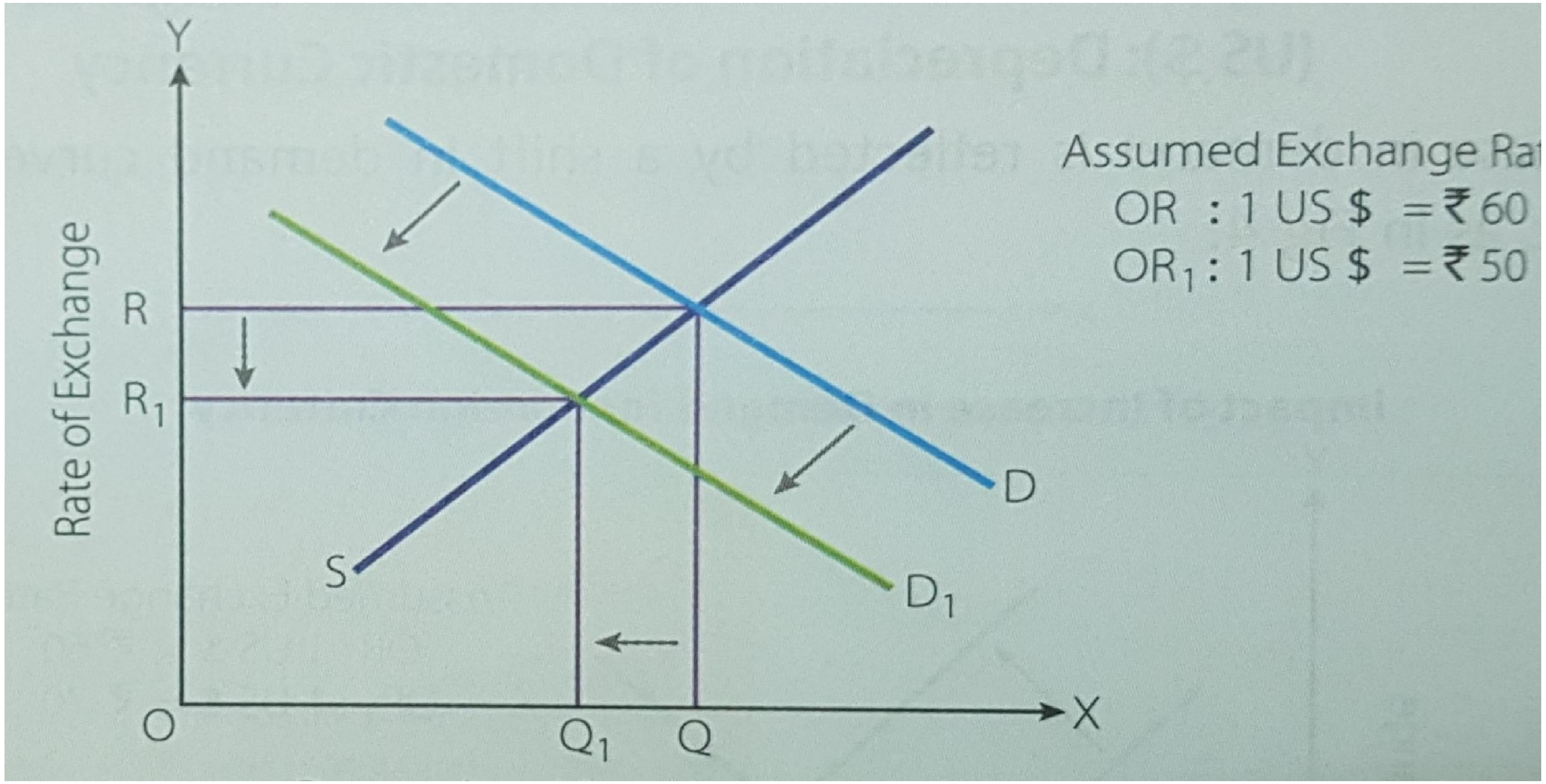
Explanation

- Demand curve shifts from D to D1. Thus causes a rise in the equilibrium exchange rate from OR to OR1.Now one US $ is available For Rs. 70,instead of Rs.60 earlier.
- Thus other things remaining constant, increase in demand for foreign currency leads to rise in exchange rate.
- This is described as situation of currency depreciation(or the depreciation of the domestic currency)

Currency Depreciation

- Refers to a situation when domestic currency (rupee) depreciates or loose its value in relation to the foreign currency (say US $). So that you need, more rupees to buy a dollar.
- Example:- If US $ exchanges for Rs.70, instead of Rs.60 earlier, the domestic currency (Indian rupee) shows depreciation.

Impact of Decrease in Demand for a Foreign Currency (US$): Appreciation of Domestic currency.



Explanation

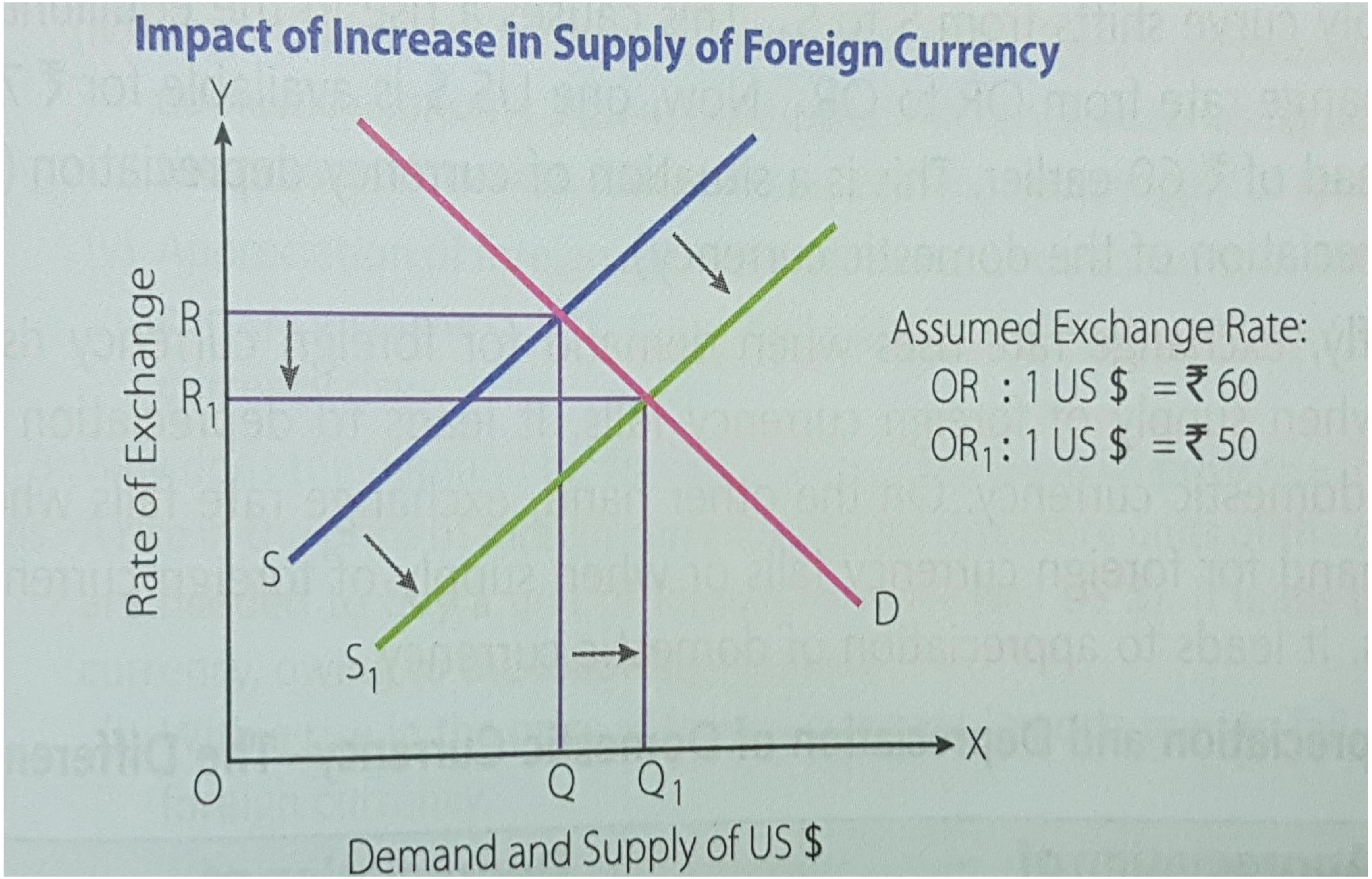
- Demand curve shift from D to D1.This causes a fall in the equilibrium exchange rate from OR to OR1. Now one US$ is available for Rs.50 instead of Rs. 60 earlier.
- Thus other things remaining constant, decrease in the demand for foreign currency leads to a fall in a Exchange rate.
- This is described as a situation of currency appreciation(or appreciation of foreign currency)

Currency Appreciation

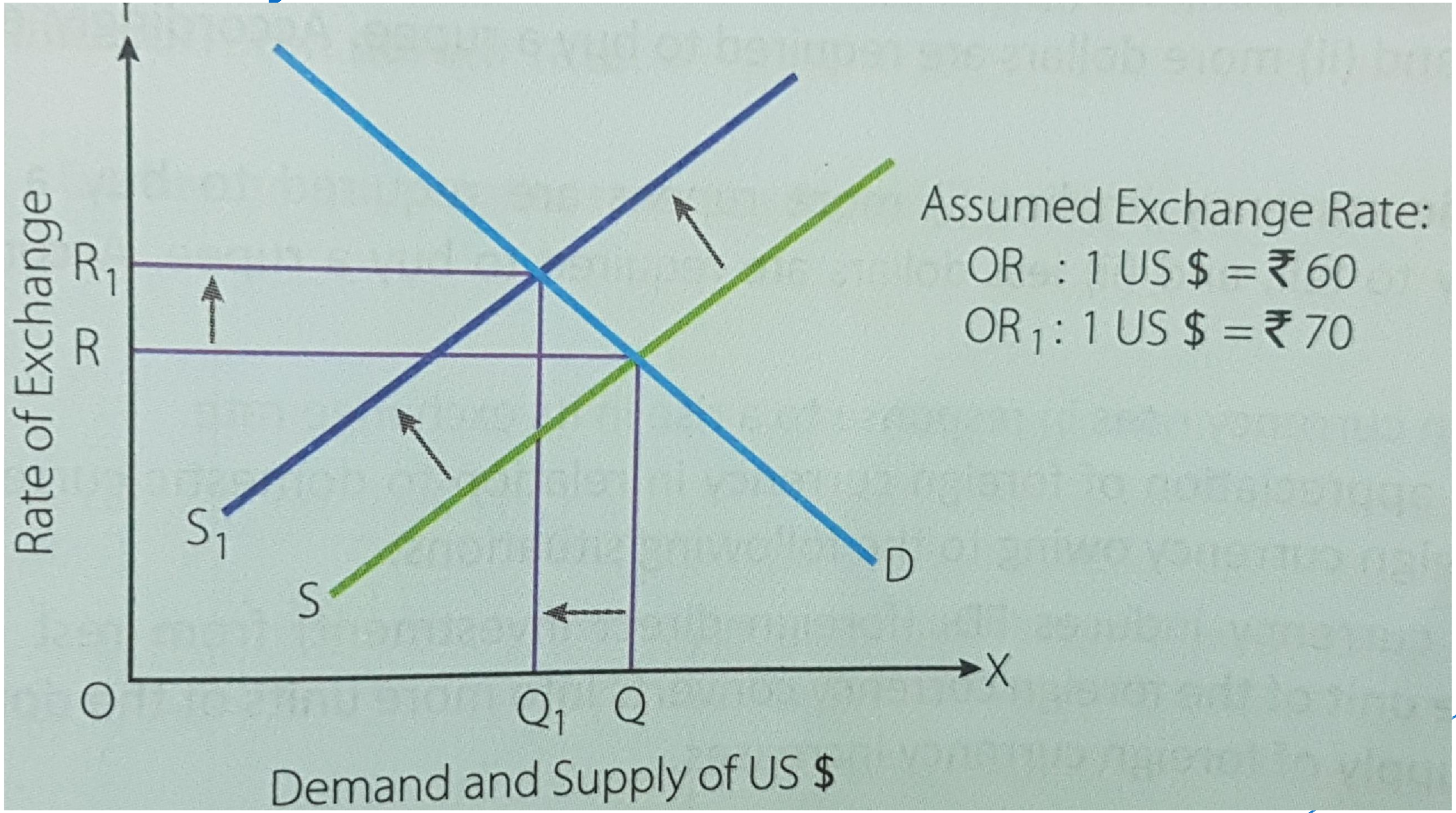
- It refers to a situation when domestic currency (rupee) appreciates(or gain its value) in relation to foreign currency(say US dollar). So that you need less rupees to buy a dollar.
- Example:- If US dollar exchange for Rs.50.instead of rupees 60 earlier.The domestic currency (Indian rupees shows appreciation)

Impact on increase in supply of foreign currency (US$): Appreciation of Domestic Currency

- Increase in supply is reflected by a shift in supply curve to the right as shown in the diagram.
- Supply curve shifts from S to S1. This causes a fall in the equilibrium exchange rate from OR to OR1.
- Now one US$ is available for rupees 50,instead of rupees 60 earlier.
- Again this a situation of currency appreciation (or appreciation of the domestic currency)


Impact of Increase in Supply of Foreign Currency
Y
Rate of Exchange
R
R1
S
S1
D
O
Q
Q1
X
Demand and Supply of US $
Assumed Exchange Rate:
OR : 1 US $ = ₹ 60
OR1 : 1 US $ = ₹ 50

Impact on Decrease in Supply of foreign currency (US$): Depreciation of Domestic Currency



Explanation:-

- Supply curve shifts from S to S1. This causes a rise in the equilibrium exchange rate from OR to OR1.
- Now, one US dollar is available for rupees 70, instead of rupees 60 earlier. This is the situation of currency depreciation (or depreciation of the domestic currency)

Fixed Exchange rate

- Exchange rate is said to be fixed when it is set or maintained by the government at a particular level.
- The government may set it at a level higher or lower than the equilibrium exchange rate as determined by the market forces of supply and demand.

Managed Floating

- Even when exchange rate is determined by the forces of supply and demand, at the time the central bank (RBI) intervenes to manage the exchange rate so that it does not slip out of the desired limits. It is called managed floating.
- It may be defined as under:
- Arranged floating is a system of floating exchange rate in which there is occasional intervention by the central bank to influence the float or manage the float. It is also called ‘Dirty Floating’.

Why the Foreign Exchange Demanded

- Repayment of International Loan.
- Investment in the rest of world.
- Imports
- Direct purchase abroad.
- Grants and donations

Components of supply of Foreign Exchange

- Exports
- Investment from rest of world.
- Direct purchase by rest of world.
- Loan from Rest of World.
- Grants and donations from rest of world.