Exchange Rate: M - R & U - Very Short - Info & Con

Q.1. Define foreign exchange.

Ans. Foreign exchange refers to currencies of other countries.

Q.2. What is foreign exchange rate?

Ans. The rate at which one currency exchanges for the other currency in the international money market is known as foreign exchange rate.

Q.3. What is meant by fixed exchange rate?

Ans. Fixed exchange rate is a rate fixed and determined by the government of a country and the government alone changes it.

Q.4. What is meant by flexible exchange rate?

Ans. Flexible exchange rate is that rate which is determined by the supply-demand forces in the foreign exchange market.

Q.5. What is 'float' rate of exchange?

Ans. Float rate of exchange refers to flexible rate of exchange as determined by the demand and supply forces of foreign exchange in the international money market.

Q.6. What is meant by managed floating exchange rate?

Ans. Managed floating is a tool employed by the central bank to restore the value of the country's currency (in relation to other currencies) within the desired limits, even when exchange rate is determined by the market forces of demand and supply.

Q.7. What is equilibrium rate of exchange?

Ans. Equilibrium rate of exchange occurs where supply of and demand for foreign exchange are equal to each other.

Q.8. Why is flexible rate of exchange called free rate of exchange?

Ans. Flexible rate of exchange is called free rate of exchange, as it is freely determined by the forces of supply and demand in the international money market.

Q.9. Give two sources of demand for foreign exchange.

Ans.

i. Payments of international loans.

ii. Gifts and grants to rest of the world.

Q.10. Give two sources of supply of foreign exchange.

Ans.

i. Purchases of domestic goods by the foreigners.

ii. Direct foreign investment as well as portfolio investment in home country.

Q.11. What is meant by currency appreciation?

Ans. Currency appreciation refers to a situation when domestic currency appreciates in relation to a foreign currency.

Q.12. What is meant by currency depreciation?

Ans. Currency depreciation refers to a situation when domestic currency depreciates in relation to a foreign currency.

Q.13. Define foreign exchange market.

Ans. Foreign exchange market is that market which handles supply and demand (and therefore, trade) of the currencies of different countries.

Q.14. What is hedging?

Ans. Hedging means protection against the risk related to variations in foreign exchange rate. Exchange rate is locked for future supplies of foreign exchange.

Q.15. Define spot market.

Ans. Spot market is that market which deals with current sale and purchase of foreign exchange.

Q.16. Define forward market.

Ans. Forward market is that market which deals with such sale and purchase of foreign exchange which are contracted today but are honoured sometimes in the future.

Q.17. What is meant by spot exchange rate?

Ans. Spot exchange rate (also known as current rate of exchange) is that rate of exchange which happens to prevail in the market at the time when transactions are incurred. It relates only to spot transactions in the international money market.

Q.18. What is meant by forward exchange rate?

Ans. Forward exchange rate is that exchange rate at which forward transactions are to be honoured. It has nothing to do with spot transactions in the international money market.

Exchange Rate M - R & U - Reason-Based Quest

Q.1. Exchange rate expresses the ratio of commodity prices.

Ans. False. Exchange rate expresses the rate at which one currency exchanges for the other.

Q.2. Fixed exchange rate is determined by the market forces.

Ans. False. Fixed exchange rate is not determined by the market forces. It is determined by the government of the country.

Q.3. Float rate of exchange refers to flexible rate of exchange.

Ans. True. Float rate of exchange refers to flexible rate of exchange as it is determined by the demand and supply forces of foreign exchange in the international money market.

Q.4. In a situation of excess demand, equilibrium exchange rate is automatically restored.

Ans. True. The free play of forces of supply and demand operate in such a manner that the excess demand is automatically eliminated and equilibrium exchange rate is automatically restored.

Q.5. Decrease in demand for foreign currency leads to currency depreciation.

Ans. False. Decrease in demand for foreign currency leads to currency appreciation. Because, decrease in demand causes a fall in exchange rate.

Q.6. In case of currency appreciation, less rupees are to be paid to buy one US dollar.

Ans. True. In case of currency appreciation, less rupees are to be paid to buy one US dollar. Because, domestic currency (rupee) gains its value in relation to US dollar.

Q.7. When in order to buy 1 US dollar ₹ 75 are needed instead of ₹ 70 earlier, domestic currency shows appreciation.

Ans. False. Here, domestic currency shows depreciation because more rupees are to be paid to buy one US dollar. Depreciation of the domestic currency implies a fall in the value of domestic currency in relation to a foreign currency.

Q.8. Export of goods and services from India to US would mean outflow of foreign exchange to India.

Ans. False. Export of goods and services from India to US would mean supply (inflow) of foreign exchange to India. Therefore, foreign exchange in terms of receipts for exports flows from US to India.

Q.9. Supply of foreign exchange is positively related to the price of foreign exchange.

Ans. True. In the international money market, supply extends when the rate of exchange rises, and it contracts when the rate of exchange falls as indicated by an upward sloping supply curve of foreign exchange.

Q.10. Appreciation of foreign currency induces lower foreign direct investment from rest of the world.

Ans. False. Appreciation of foreign currency induces greater foreign direct investment from rest of the world. Because, now one unit of the foreign currency exchanges for more units of the domestic currency.

Q.11. In order to restore the value of depreciating domestic currency, central bank buys the US dollars in the international money market.

Ans. False. In order to restore the value of depreciating domestic currency, central bank sells the US dollars in the international money market. By selling the dollars, the bank expects to increase the supply of dollars in the market. Other things remaining constant, increase in supply is expected to reduce the price of dollar in relation to the domestic currency.

Bal of Pay A M - R & U - Very Short - Info & Con

Q.1. Define balance of payments.

Ans. Balance of payments refers to the statement of accounts recording all economic transactions of a country with rest of the world in an accounting year.

Q.2. What does balance of payments account show?

Ans. Balance of payments account is a summary statement of all economic transactions between a country and rest of the world. Each country enters into economic transactions with other countries of the world. As a result of such transactions, it receives payments from and makes payments to other countries. The balance of payments is a statement of accounts of these receipts and payments.

Q.3. Name the two parts of the balance of payments account.

Ans. Two parts of the balance of payments account are:

i. Current account of balance of payments.

ii. Capital account of balance of payments.

Q.4. Define balance of trade.

Ans. Balance of trade is defined as the difference between the value of imports and exports of only physical goods or visible items.

Q.5. Which two transactions determine balance of trade?

Ans.

i. Export of goods.

ii. Import of goods.

[Both are visible items of trade.]

Q.6. What is the difference between the value of exports and value of imports called?

Ans. The difference between the value of exports and value of imports is called balance of trade.

Q.7. What is meant by visible items of balance of payments?

Ans. All such items of exports and imports which are material in nature are called visibles. These items can be seen crossing the borders. These are also called merchandise.

Q.8. What is meant by invisible items of balance of payments?

Ans. Invisible items refer to all types of services which are rendered to rest of the world as exports or received from the rest of the world as imports as well as current transfers.

Q.9. Give two examples of invisible items.

Ans. Examples of invisible items are:

- **i.** export and import of shipping services, and
- **ii.** export and import of banking services.

Q.10. Name three such items which are not included in balance of trade.

Ans. Three items which are not included in balance of trade are:

- **i.** Export and import of services such as of shipping, insurance and banking.
- **ii.** Interest and dividend payments between the countries.
- **iii.** Expenditure by the tourists.

Q.11. When will balance of trade show a deficit?

Or

What does deficit in balance of trade indicate?

Ans. Deficit in balance of trade occurs when:

Export of goods < Import of goods.

Q.12. When will balance of trade show a surplus?

Ans. Surplus in balance of trade occurs when:

Export of goods > Import of goods.

Q.13. Define current account of balance of payments.

Ans. Current account of balance of payments is that account which records export and import of goods, and invisibles. It is a statement of actual receipts and payments of a country on account of imports and exports of both visible and invisible items.

Q.14. Define capital account of balance of payments.

Ans. Capital account of balance of payments is that account which records all such transactions between residents of a country and rest of the world which cause a change in ownership of assets. It is a statement of all capital inflows and outflows during the period of an accounting year.

Q.15. Name two items each relating to current account BoP and capital account BoP.

Ans.

- **i.** Current Account BoP includes:
  - **a.** export and import of goods (called merchandise), and
  - **b.** export and import of services (called invisibles).
- **ii.** Capital Account BoP includes:
  - **a.** international sale and purchase of financial assets (like stocks and bonds), and
  - **b.** international sale and purchase of real assets (like plant and machinery).

Q.16. Define balance of payments equilibrium.

Ans. Balance of payments equilibrium is a situation when receipts and payments of a country on account of economic transactions with rest of the world are exactly equal to each other, and there is no movement of official reserves.

Q.17. When will deficit in the balance of payments occur?

Ans. Deficit in the balance of payments occurs when payments of a country on account of economic transactions with rest of the world exceed its receipts and consequently, there is a decrease in official reserves.

Q.18. When will surplus in the balance of payments occur?

Ans. Surplus in the balance of payments occurs when receipts of a country on account of economic transactions with rest of the world exceed its payments and consequently, there is increase in official reserves.

Q.19. Define autonomous items.

Ans. Autonomous items are those transactions that are undertaken for certain economic or profit motive. These items are also known as above the line items. It is due to these items that there is surplus or deficit in the BoP account.

Q.20. Define accommodating items.

Ans. Accommodating items are those transactions that are undertaken by the government with a view to correcting imbalances in the country’s BoP account. These items are also known as below the line items.

Bal of Pay A: M - R & U - Reason-Based Quest

Q.1. Monetary transactions arise only due to international sale and purchase of financial assets.

Ans. False. Monetary transactions arise due to export and import of goods, export and import of services, international sale and purchase of financial assets as well as international sale and purchase of real assets.

Q.2. If exports > imports, the level of aggregate demand tends to fall.

Ans. False. If exports > imports, the level of aggregate demand tends to rise. Because exports lead to a rise in AD, while imports are the opposite of exports.

Q.3. BoP accounts reflect the growth potential of the economy.

Ans. True. BoP accounts reflect the growth potential of the economy in terms of demand for the domestically produced goods and services in rest of the world.

Q.4. Balance of trade is the difference between export of services and import of services of a country.

Ans. False. Balance of trade is the difference between export of material goods and import of material goods of a country. It relates only to visible items of trade.

Q.5. While estimating invisibles balance, we consider goods and non-factor services only.

Ans. False. While estimating invisibles balance, we consider

- **i.** balance relating to non-factor services,
- **ii.** balance relating to factor services, and
- **iii.** balance on current transfers.

Q.6. Current account is a part of balance of trade.

Ans. False. Balance of trade is a part of current account.

Balance on Current Account = Trade balance + Invisibles balance

Q.7. Import of machinery is reflected in the capital account of balance of payments.

Ans. False. Import of machinery (which is a capital good) is reflected in the current account of balance of payments as an element of merchandise.

Q.8. Portfolio investment relates to ownership of enterprises by the non-residents in the domestic economy.

Ans. False. Portfolio investment refers to investment by the non-residents in shares and bonds of the domestic companies.

Q.9. When BoP is in equilibrium, there is movement of official reserves of the central bank.

Ans. False. When BoP is in equilibrium:

Current account balance + Capital account balance + Errors and omissions = Zero, and there is no movement of official reserves of the central bank.

Q.10. BoP is in surplus when: Current account balance + Capital account balance is not equal to zero.

Ans. True. In case of surplus in BoP:

Current account balance + Capital account balance is some positive number, pointing to net inward flow of foreign exchange, and causing an increase in official reserves.

Q.11. Accommodating items do not cause any movement of goods and services across the borders.

Ans. True. Accommodating items relate only to the movement of official reserves with a view to correcting BoP imbalances.

Q.12. If balance of trade is showing a deficit of ₹ 20,000 and value of exports is ₹ 30,000, then the value of imports will be ₹ 10,000.

Ans. False. Value of imports in this case will be ₹ 50,000.

We know that,

Balance of Trade = Value of exports – Value of imports

Or, Value of Imports = Value of exports – Balance of trade

= ₹ 30,000 – (–) ₹ 20,000

= ₹ 30,000 + ₹ 20,000

= ₹ 50,000

Therefore, value of imports will be ₹ 50,000

HOTS & Applications

Q.1. Is a rise in reserves of India's foreign exchange a sign of our rising exports?

Ans. Not necessarily; in case of India it is certainly not. Our forex reserves have tended to rise largely because of remittances from abroad by the NRIs.

Q.2. How does 'export/import' component affect the circular flow of income in a country?

Ans. Exports reflect expenditure on the domestic product by the rest of the world. It leads to increase in AD and works as an 'injection' into the circular flow of income. It stimulates the flow of income by way of 'multiplier effect'. Imports, on the other hand, is a 'withdrawal' from the circular flow of income. It depresses the flow of income by way of negative multiplier effect.

Q.3. Balance of payments always balances. Does it mean a situation of zero net financial obligation for a country?

Ans. It is only in the accounting sense that balance of payment always balances. From the practical point of view, it should not be interpreted as a situation of zero net financial obligation for a country. A negative balance on the current account is equated with positive balance in the capital account. But the positive balance in capital account may have been achieved through loans from rest of the world. All loans are financial obligations to rest of the world.

Q.4. How does balance of payments reflect supply, demand status of foreign exchange for a country?

Ans. Unfavourable balance of payments of a country (like India) shows that our financial obligations vis-a-vis rest of the world are greater than our financial claims. It reflects that:

- **a.** availability (supply) of forex reserves is low, and
- **b.** demand for forex reserves is high. Implying a net rise in the demand for foreign exchange.

This leads to a rise in the price of 'forex' (the rate at which we can buy a dollar or a pound). Thus, exchange rate becomes unfavourable.

Q.5. How is the rising demand for the Indian goods in the US market likely to impact the exchange rate between the Indian rupee and US dollar?

Ans. Rising demand for the Indian goods in the US market imply that our exports are tending to rise. Consequently, supply of foreign exchange (US dollar) tends to rise. Other things remaining constant, it would lead to a fall in foreign exchange rate. Implying that the domestic currency (Indian rupee) will start appreciating in relation to the US dollar.