Under CSR Support by
ipca | Foundation

missiongyan
LET'S LEARN TOGETHER



CLASS – 12

ECONOMICS

Introductory Macroeconomics

CH-6 : Open Economy Macroeconomics

Part – 1
Introduction to Foreign Exchange Market

Vaishnavi Agrawal

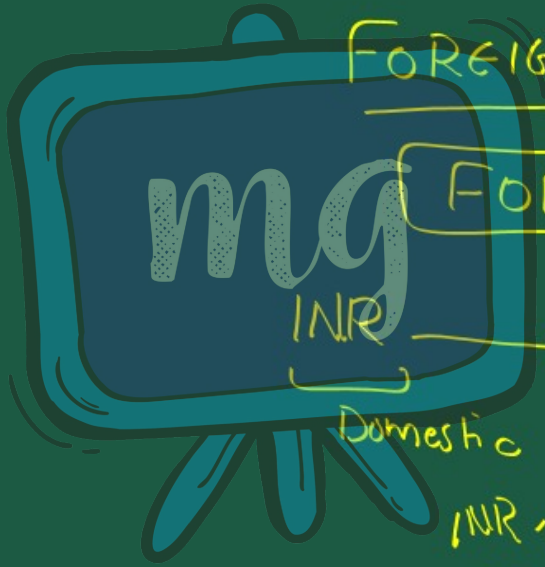
OVERVIEW



1. Introduction to Foreign Exchange Market
2. Determination of Exchange Rate
3. Balance of Payment

Under CSR Support by ipca | Foundation

missiongyan LET'S LEARN TOGETHER



FOREIGN EXCHANGE

FOREX

INR → USD, AUD, EURO

INR

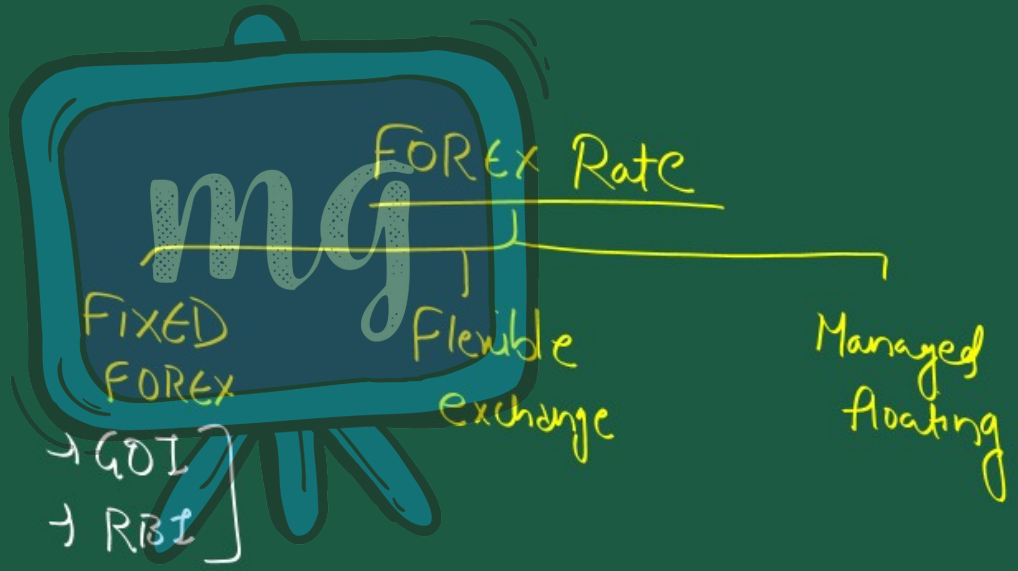
Domestic

INR - USD — FOREX Rate

1$ = 85.88 INR

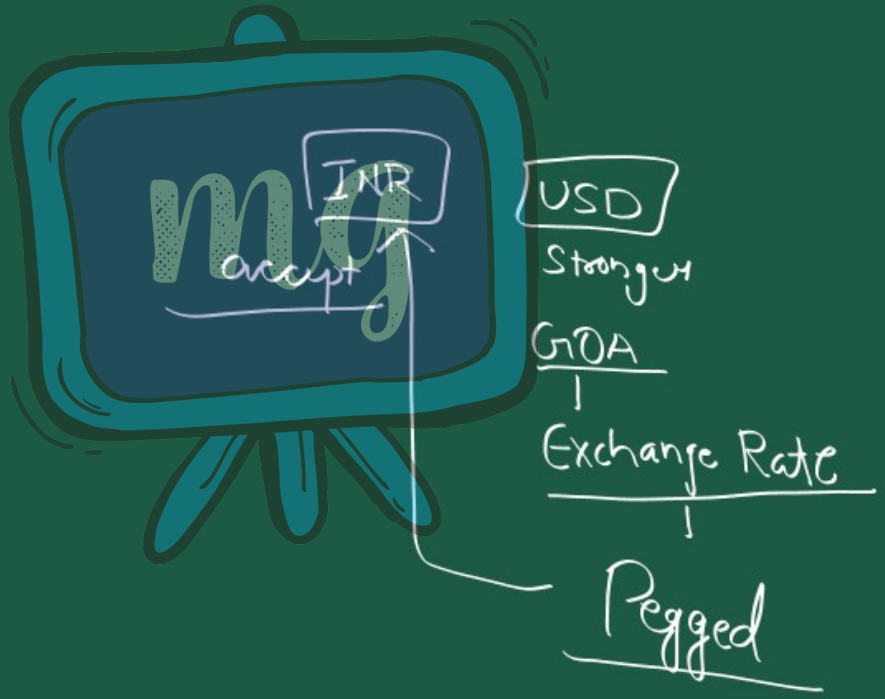
Under CSR Support by
ipca | Foundation

missiongyan
LET'S LEARN TOGETHER



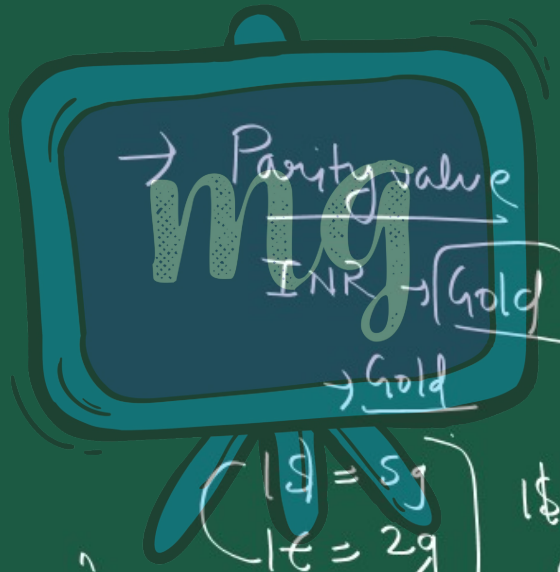
Under CSR Support by
ipca | Foundation

missiongyan
LET'S LEARN TOGETHER



Under CSR Support by ipca | Foundation

missiongyan LET'S LEARN TOGETHER



∴

1$ = 5g
1€ = 2g

1$ = 1€

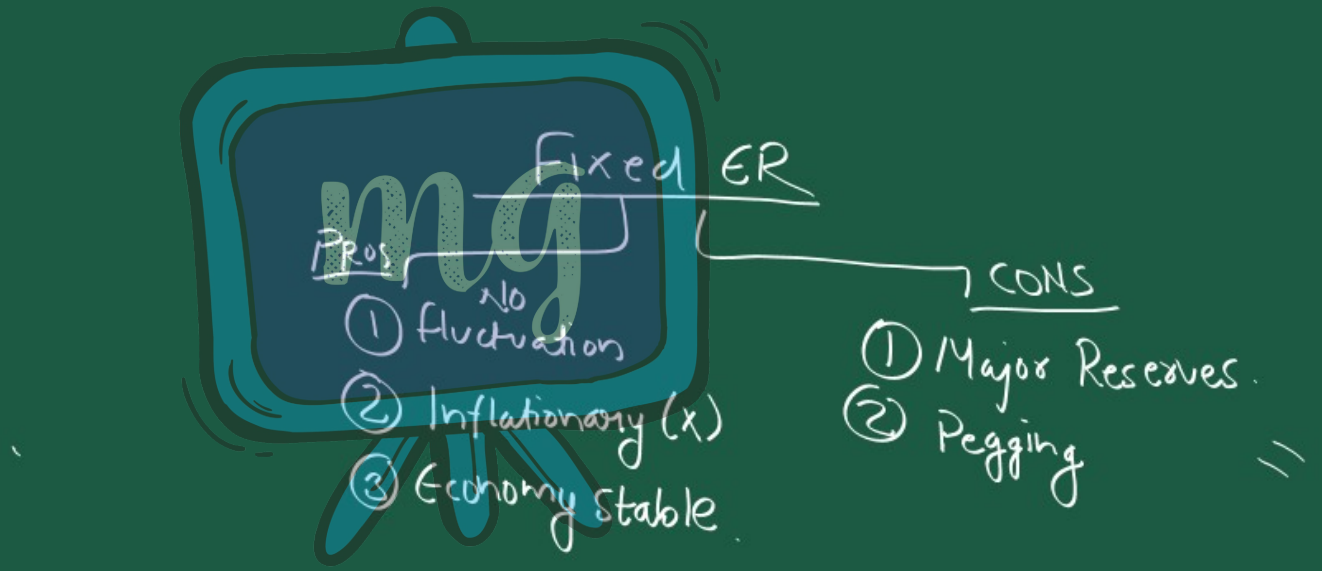
→ Bretten wood System

USD *

fail

Under CSR Support by ipca | Foundation

missiongyan LET'S LEARN TOGETHER



Under CSR Support by ipca | Foundation

missiongyan LET'S LEARN TOGETHER



Flexible
Exchange Rate

→ Market forces

→ No Intervention of GOI + CB (RBI)

→ free exchange Rate

floating exchange Rate

Under CSR Support by ipca | Foundation

missiongyan LET'S LEARN TOGETHER



CONs

→ Inflationary pressure

→ Economic fluctuations.

Under CSR Support by ipca | Foundation

missiongyan LET'S LEARN TOGETHER



Managed floating (DIRTY floating)

1→ Market forces (Det)

2) GOI + RBI → Intervene

fluctuation
economy
Inflation

(target value)

Under CSR Support by
ipca | Foundation

missiongyan
LET'S LEARN TOGETHER



FOREIGN EXCHANGE

- It refers to all the currencies of the rest of the world other than the domestic currency of the country.
- Example : In India, US dollar is the foreign exchange. (Except Indian Rupee (INR), all other currencies USD, AUD are foreign exchange.)
- Denoted as 'FOREX'.



Under CSR Support by
ipca | Foundation

missiongyan
LET'S LEARN TOGETHER

FOREIGN EXCHANGE RATE

- The rate at which one currency is exchanged for another.
- Example : 1 USD = 85.83 INR

US = 10,000 USD

1$ USD = 80 INR

80 x 10,000



Under CSR Support by
ipca | Foundation

missiongyan
LET'S LEARN TOGETHER

Types of Foreign Exchange Rates



1. Fixed Exchange Rate
   - Pegged exchange
2. Flexible Exchange Rate
3. Managed Floating Rate

Under CSR Support by
ipca | Foundation

missiongyan
LET'S LEARN TOGETHER

FIXED EXCHANGE RATE

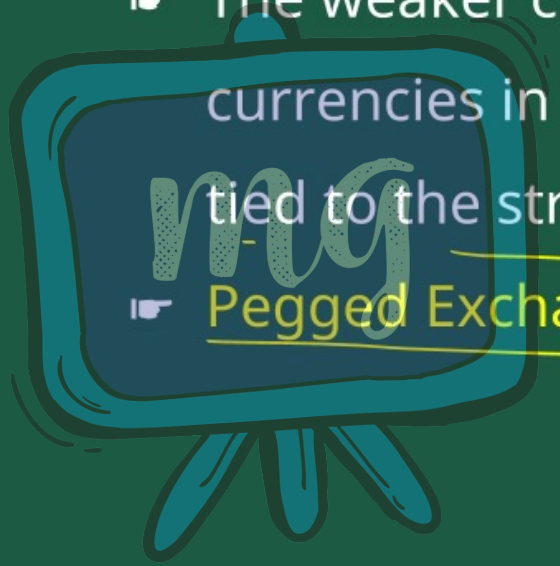
- Exchange Rate of the currency is Fixed by the Central authority of the Country.
- Determined by the Government of the Country or the Central Bank. (RBI)



Under CSR Support by
ipca | Foundation

missiongyan
LET'S LEARN TOGETHER

- Not dependent on Market Forces.
- The weaker currency of the two currencies in question is pegged or tied to the stronger currency.
- Pegged Exchange Rate



Under CSR Support by
ipca | Foundation

missiongyan
LET'S LEARN TOGETHER



Pegging

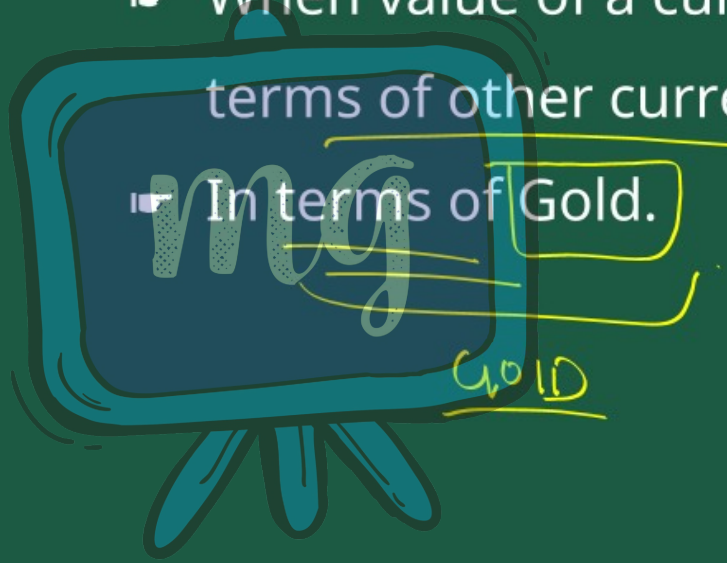
- There is purchasing of foreign exchange by the central bank or government when the rate of foreign currency increases.
- Selling foreign currency when the rates fall.
- This process is known as pegging.

Under CSR Support by
ipca | Foundation

missiongyan
LET'S LEARN TOGETHER

Parity Value

- When value of a currency is fixed in terms of other currency.
- In terms of Gold.



Under CSR Support by
ipca | Foundation

missiongyan
LET'S LEARN TOGETHER

Gold Standard System

- External values of all currencies were maintained by fixing their prices in terms of gold.
- Central bank of each country was ready to buy and sell unlimited quantities of gold at a fixed price in terms of its own currency.

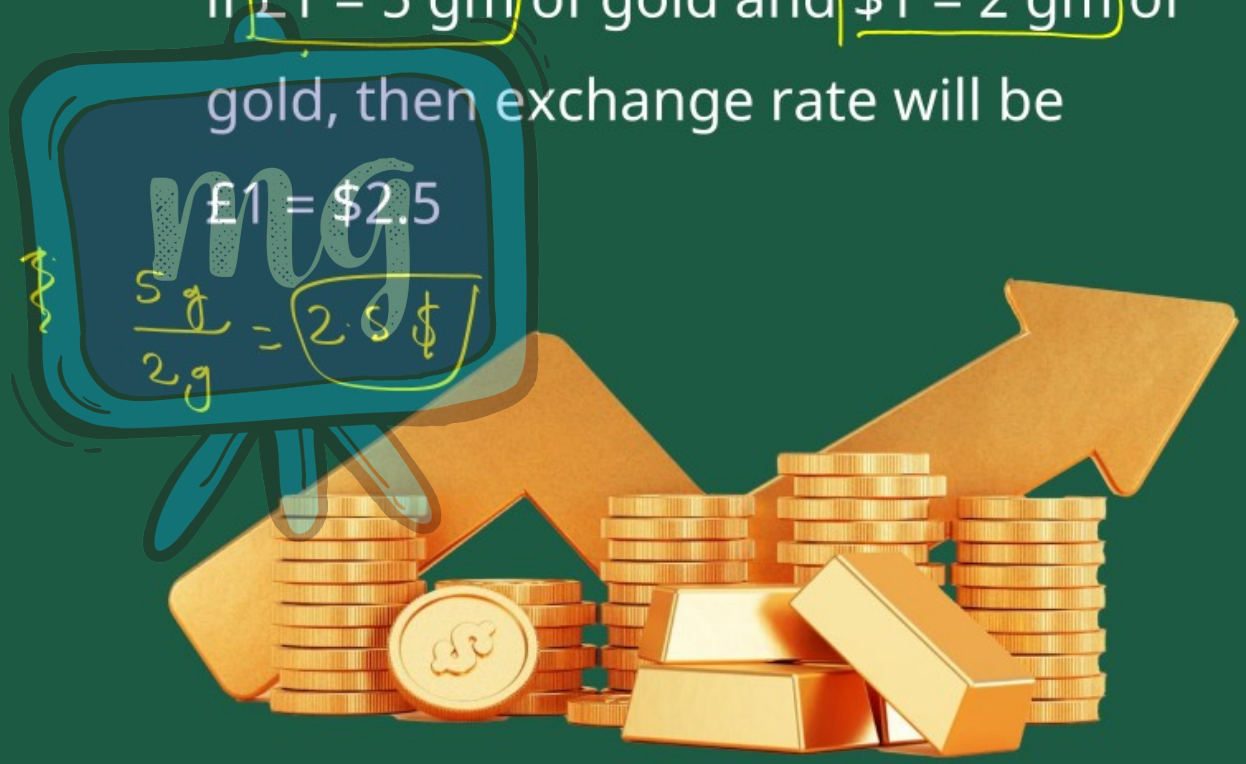
Under CSR Support by
ipca | Foundation

missiongyan
LET'S LEARN TOGETHER

☛ Example

if £1 = 5 gm of gold and $1 = 2 gm of gold, then exchange rate will be

£1 = $2.5



Under CSR Support by
ipca | Foundation

missiongyan
LET'S LEARN TOGETHER

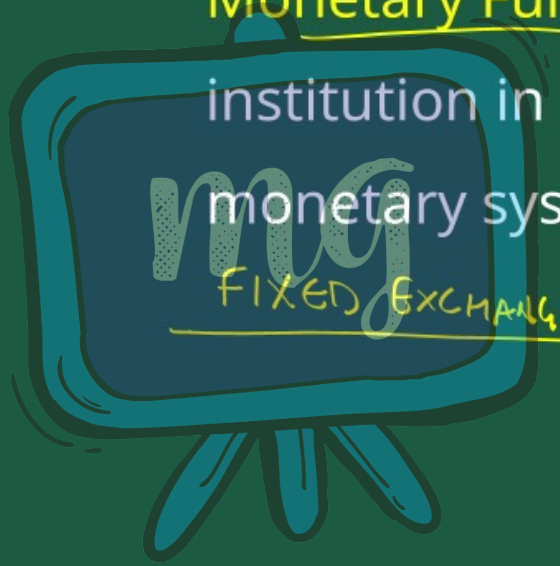
- According to Bretton Woods Standard, gold was replaced by US dollar as the 'core' of the system.
- Under this system, all currencies were pegged or related to US dollar at a fixed exchange rate.



Under CSR Support by
ipca | Foundation

missiongyan
LET'S LEARN TOGETHER

- This system gave birth to International Monetary Fund (IMF) as the central institution in the international monetary system.



Under CSR Support by
ipca | Foundation

missiongyan
LET'S LEARN TOGETHER

Advantages

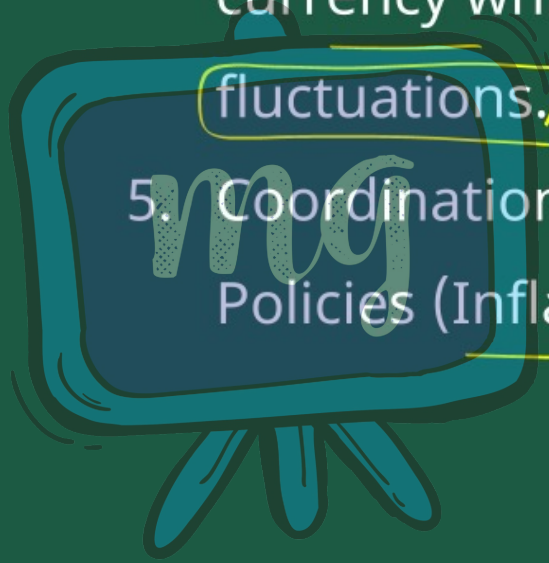
1. Ensures Stability in foreign exchange.
2. Encourages foreign trade.
3. Promotes International Investment.



Under CSR Support by
ipca | Foundation

missiongyan
LET'S LEARN TOGETHER

4. There is a stability in the value of currency which protects it from market fluctuations.
5. Coordination of Macro Economic Policies (Inflation rates in an economy).



Under CSR Support by
ipca | Foundation

missiongyan
LET'S LEARN TOGETHER

Disadvantages

1. There is a constant need for maintaining foreign reserves in order to stabilize the economy.
2. The government may lack the flexibility that is required to bounce back in case an economic shock engulfs the economy.



Under CSR Support by
ipca | Foundation

missiongyan
LET'S LEARN TOGETHER



FLEXIBLE EXCHANGE RATE

- Exchange Rate of the currency fluctuate freely by the market forces.
- Determined by Demand and Supply of other currencies.
- No Government intervention.
- 'Floating Exchange Rate', 'Free Exchange Rate'.

Under CSR Support by
ipca | Foundation

missiongyan
LET'S LEARN TOGETHER

Advantages

1. There is no need to maintain foreign reserves in this exchange system.
2. Maintains Equilibrium Level.
3. Optimum Utilization of Resources.



Under CSR Support by
ipca | Foundation

missiongyan
LET'S LEARN TOGETHER

Disadvantages

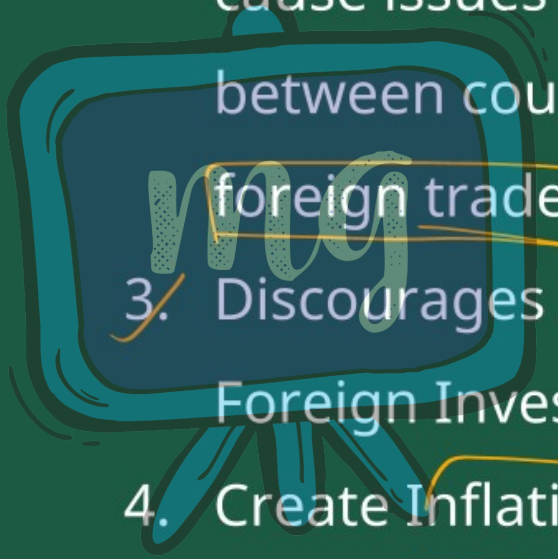
1. Lead to fluctuations in the exchange rate of currencies in the market.



Under CSR Support by
ipca | Foundation

missiongyan
LET'S LEARN TOGETHER

2. Fluctuations in exchange rates can cause issues with movement of capital between countries and also impact foreign trade. Transactions



3. Discourages International Trade and Foreign Investment.
4. Create Inflationary Situations.

Under CSR Support by ipca | Foundation

missiongyan LET'S LEARN TOGETHER

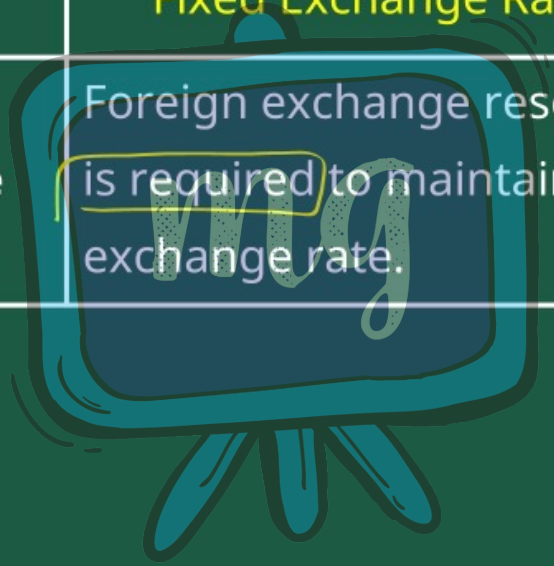
FIXED EXCHANGE RATE VS FLEXIBLE EXCHANGE RATE

Basis	Fixed Exchange Rate	Flexible Exchange Rate
Determination of Exchange Rate	Fixed by government. RBI	Determined by market forces.
Government Control	Complete government intervention.	No government intervention.
Stability in Exchange Rate	Only a small variation in exchange rate is possible. STABLE	Exchange rate keeps on changing.

Under CSR Support by
ipca | Foundation

missiongyan
LET'S LEARN TOGETHER

FIXED EXCHANGE RATE VS FLEXIBLE EXCHANGE RATE		
Basis	Fixed Exchange Rate	Flexible Exchange Rate
Foreign Exchange Reserves	Foreign exchange reserve is required to maintain the exchange rate.	Foreign exchange reserves are not required.



Under CSR Support by
ipca | Foundation

missiongyan
LET'S LEARN TOGETHER

MANAGED FLOATING RATE



- The combination of the fixed and floating exchange rate systems.
- RBI maintains Foreign Exchange Reserves to ensure Exchange Rate remains under targeted values.
- Dirty Floating

Under CSR Support by
ipca | Foundation

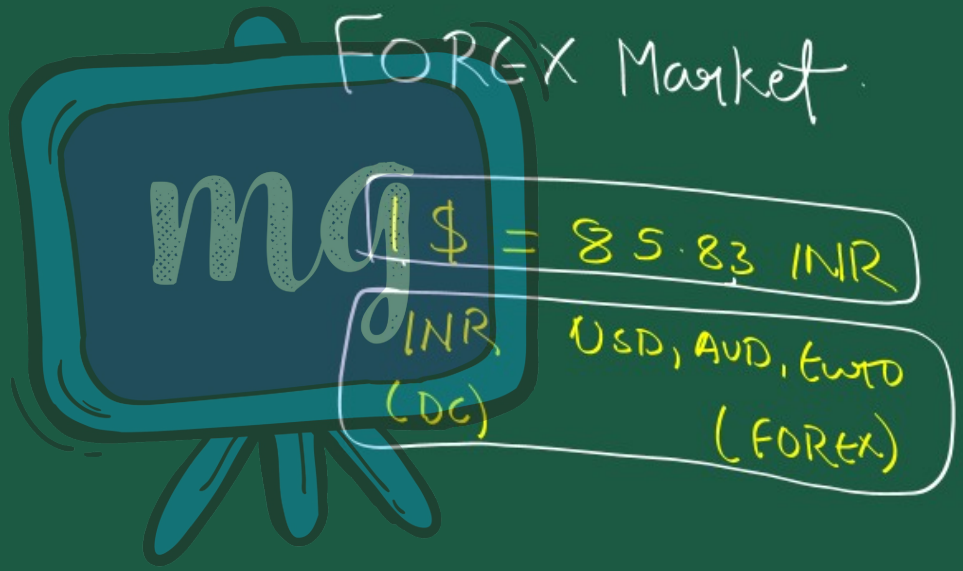
missiongyan
LET'S LEARN TOGETHER

- Exchange rate is determined by market forces.
- The central banks intervene in the purchase or selling of the foreign currencies and influence Exchange Rates.
- RBI intervenes to restrict fluctuations in the exchange rates.



Under CSR Support by
ipca | Foundation

missiongyan
LET'S LEARN TOGETHER



Under CSR Support by
ipca | Foundation

missiongyan
LET'S LEARN TOGETHER

FOREIGN EXCHANGE MARKET

- Markets in which you can trade one kind of money currency for another currency.
- The market where currencies are traded.
- Currency market.

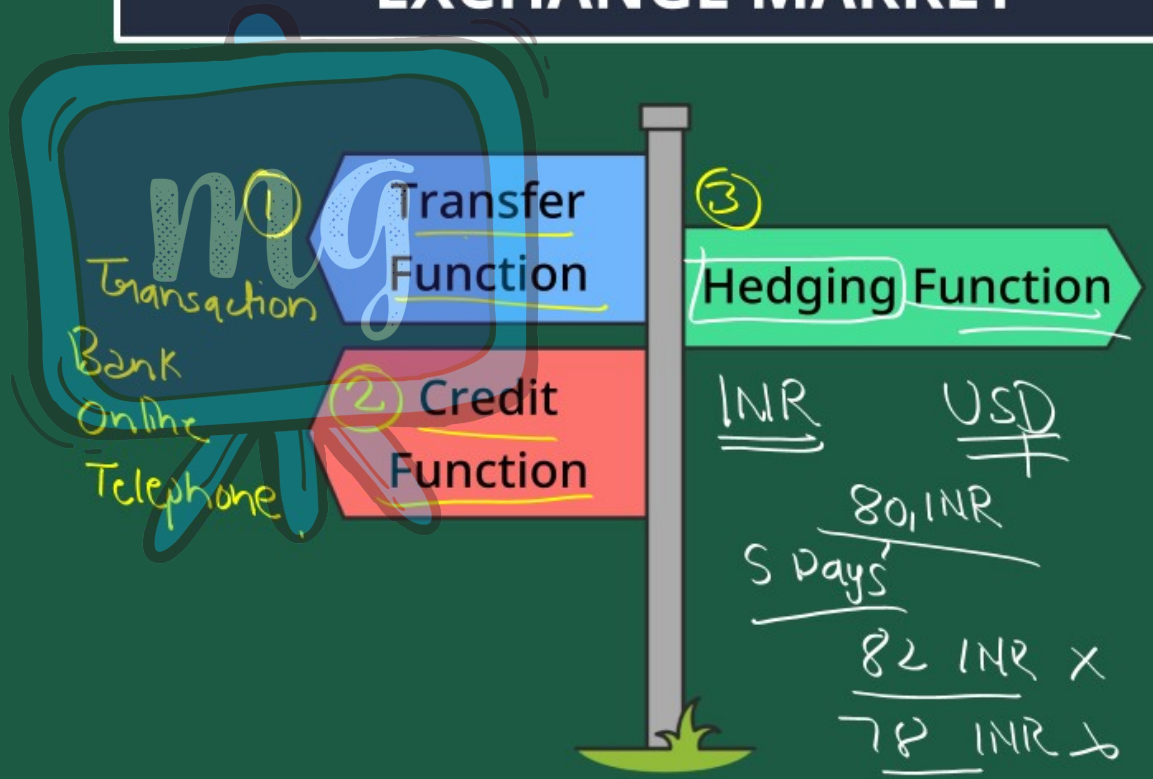
10 USD → 1 INR



Under CSR Support by
ipca | Foundation

missiongyan
LET'S LEARN TOGETHER

FUNCTIONS OF FOREIGN EXCHANGE MARKET



Under CSR Support by
ipca | Foundation

missiongyan
LET'S LEARN TOGETHER

TRANSFER FUNCTION

- Bills of Foreign Exchange, Bank Drafts, Telephonic Transfers.
- Transfer of purchasing power between countries involved in transactions.



Under CSR Support by
ipca | Foundation

missiongyan
LET'S LEARN TOGETHER

CREDIT FUNCTION

Provides Credit for Foreign Trade.



Under CSR Support by
ipca | Foundation

missiongyan
LET'S LEARN TOGETHER

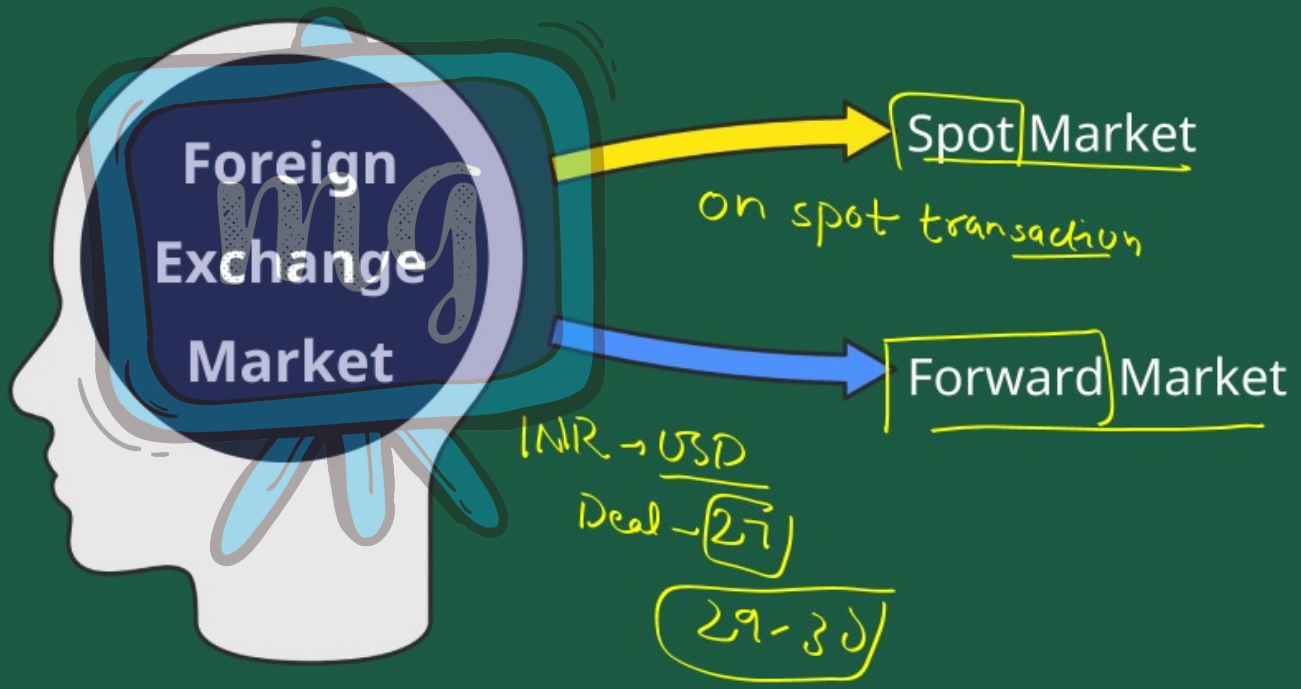
HEDGING FUNCTION

When exporters and importers enter into an agreement to sell and buy some goods on some future dates at the current price and exchange rate.



Under CSR Support by
ipca | Foundation

missiongyan
LET'S LEARN TOGETHER



Under CSR Support by
ipca | Foundation

missiongyan
LET'S LEARN TOGETHER

SPOT MARKET

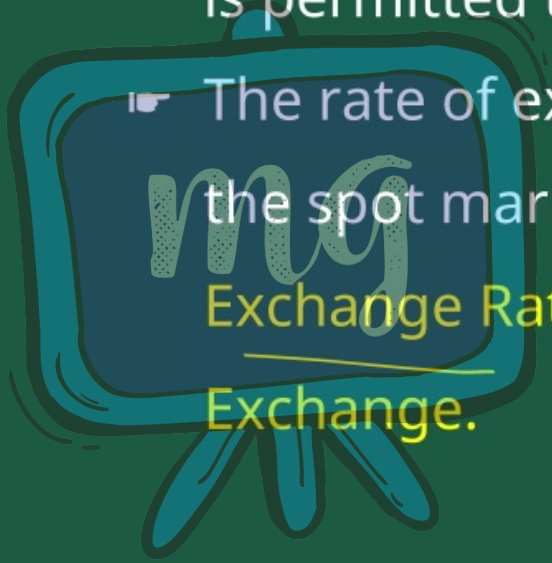
- The market in which the receipts and payments are made immediately.
- Daily nature market
- Deals only in spot transactions of not in future transactions.



Under CSR Support by
ipca | Foundation

missiongyan
LET'S LEARN TOGETHER

- Generally, a time of two business days is permitted to settle the transaction.
- The rate of exchange, which prevails in the spot market, is termed as Spot Exchange Rate or Current Rate of Exchange.



Under CSR Support by
ipca | Foundation

missiongyan
LET'S LEARN TOGETHER



FORWARD MARKET

- The market in which sale and purchase of foreign currency is settled on a specified future date at a rate agreed upon today.
- The exchange rate quoted in forward transactions is known as the Forward Exchange Rate.

Under CSR Support by
ipca | Foundation

missiongyan
LET'S LEARN TOGETHER

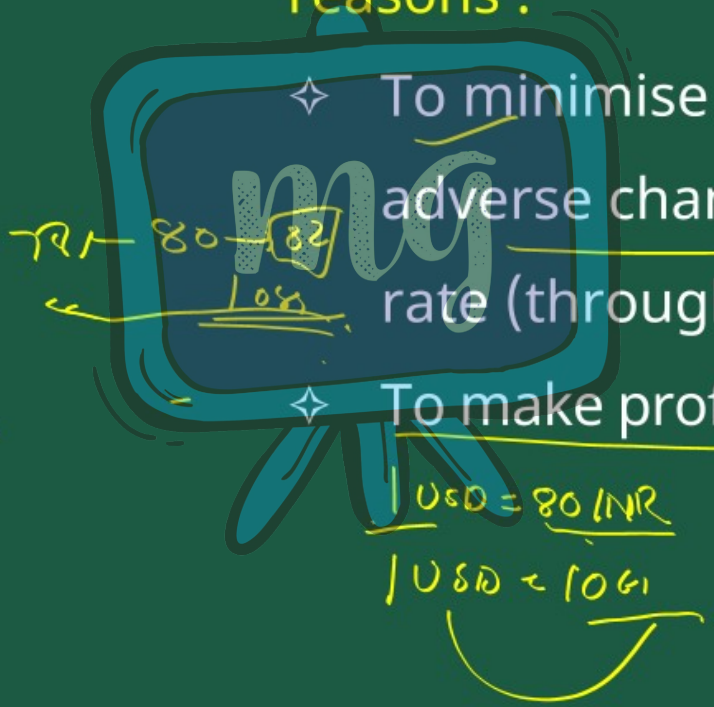


- Generally, most of the international transactions are signed on one date and completed on a later date.
- Forward exchange rate becomes useful for both the parties involved in the transaction.

Under CSR Support by ipca | Foundation

missiongyan LET'S LEARN TOGETHER

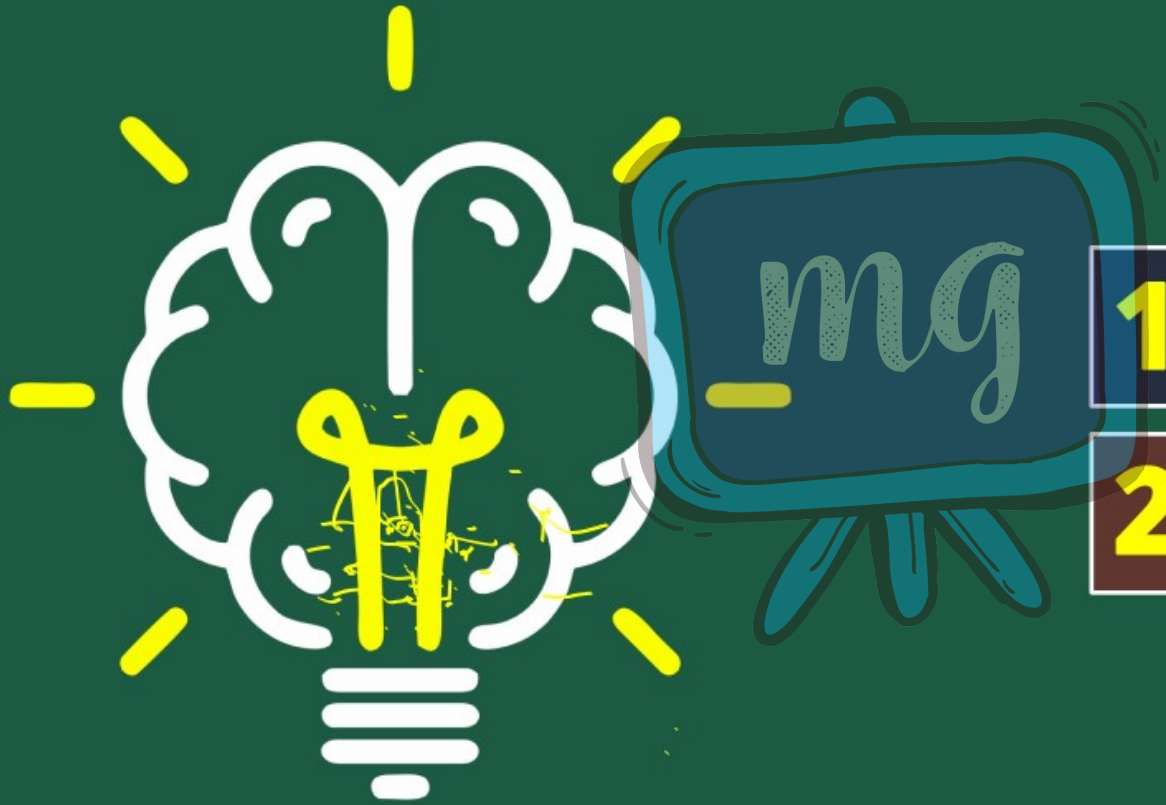
- Forward Contract is made for two reasons :
  - To minimise the risk of loss due to adverse changes in the exchange rate (through hedging)
  - To make profit (through speculation).



Under CSR Support by ipca | Foundation

LEARNING OUTCOMES

missiongyan LET'S LEARN TOGETHER



1 Foreign Exchange Market

2 Types of Foreign Exchange Rates

ASSESSMENT



1 Which of the following is the primary function of the foreign exchange market?

A To facilitate international trade.

B To facilitate international investment.

C To determine the exchange rates between different currencies.

D All of the above



2 Under a fixed exchange rate system, which of the following is true?

A The government allows the exchange rate to fluctuate freely.

B The government pegs in the foreign exchange currency value.

C The exchange rate is determined by the market forces of supply and demand.

D Both A and C.



3 Under a flexible exchange rate system, which of the following is true?

A The government fixes the exchange rate.

B The central bank intervenes in the foreign exchange market to determine the exchange rate.

C The exchange rate is determined by the market forces of supply and demand.

D The exchange rate is fixed for a specific period of time.



4 Under a managed floating exchange rate system, which of the following is true?

A. The exchange rate is completely determined by market forces.

B. The central bank intervenes in the foreign exchange market to influence the exchange rate after being determined by the market forces.

C. The exchange rate is fixed for a specific period of time.

D. None of the above