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CLASS – 12

ECONOMICS

Introductory Macroeconomics

CH-6 : Open Economy Macroeconomics

Part – 2

Determination of Exchange Rate

Vaishnavi Agrawal

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OVERVIEW

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

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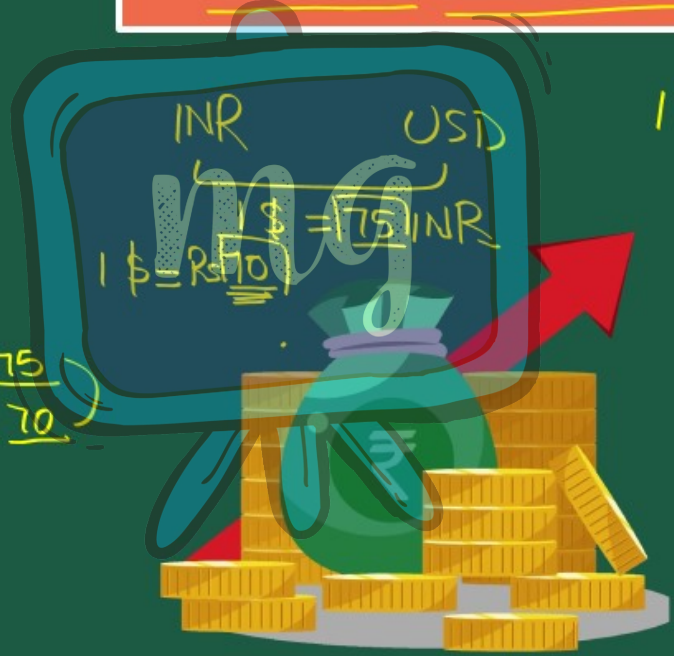
APPRECIATION AND DEPRECIATION OF CURRENCY



1 $ = 80 NR



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CURRENCY APPRECIATION

- Refers to Increase in the value of Domestic currency in terms of Foreign Currency.
- The domestic currency becomes more valuable.



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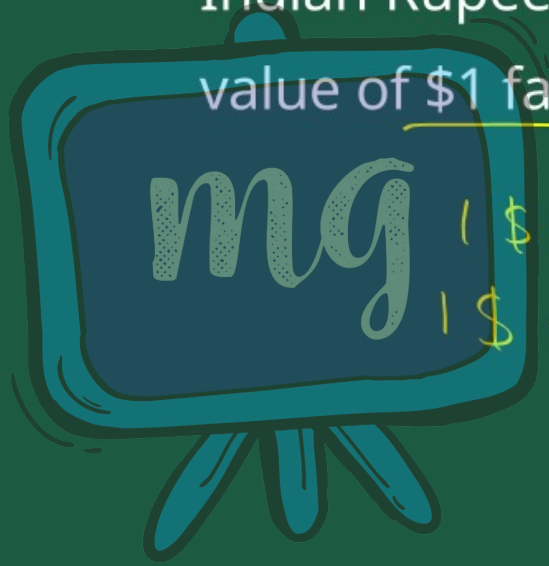
☛ Example

Indian Rupee appreciates when the value of $1 falls from Rs. 75 to Rs.70.



1 $ = 75 INR

1 $ = 70 INR

INR = ₹5

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Effects of Appreciation of a Currency



1. Decrease in Exports of goods
2. Increase in Imports of goods
3. Decrease in National Income

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CURRENCY DEPRECIATION

- Refers to Decrease in the value of Domestic currency in terms of Foreign Currency.
- The domestic currency becomes less valuable.
- Example

Indian Rupee depreciates when the value of $1 rises from Rs. 70 to Rs.75.

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Effects of Depreciation of a Currency



1. Increase in Exports of goods
2. Decrease in Imports of goods
3. Increase in National Income

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CURRENCY DEPRECIATION VS CURRENCY APPRECIATION		
Basis	Currency Appreciation	Currency Depreciation
Meaning	Increase in the value of domestic currency in terms of foreign currency.	Decrease in the value of domestic currency in terms of foreign currency.
Effect on Imports/ Exports	Leads to increase in imports ↑	Leads to increase in exports ↑
Example	A change from $1 = ₹74 to $1 = ₹70 (Indian Rupees appreciates)	A change from $1 = ₹70 to $1 = ₹74 (Indian Rupees depreciates)

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DEVALUATION AND REVALUATION



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CURRENCY DEVALUATION

- Refers to Decrease in the value of Domestic currency in terms of Foreign Currency by the government intervention.



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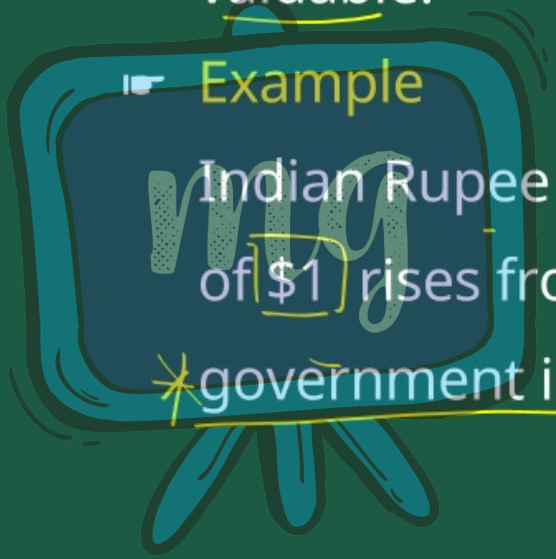
- The domestic currency becomes less valuable.
- Example

Indian Rupee devaluates when the value of $1 rises from Rs. 70 to Rs.75 by the government intervention.



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CURRENCY REVALUATION

- Refers to Increase in the value of Domestic currency in terms of Foreign Currency by the Government Intervention.
- The domestic currency becomes more valuable.



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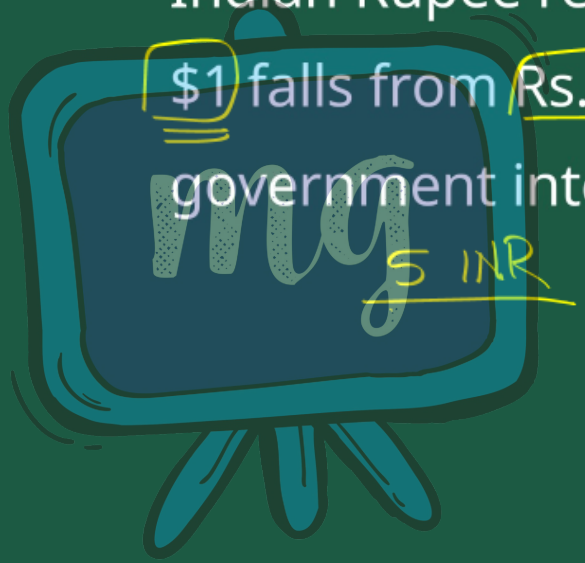
☛ Example

Indian Rupee revaluates when the value of $1 falls from Rs. 75 to Rs.70 by the government intervention.



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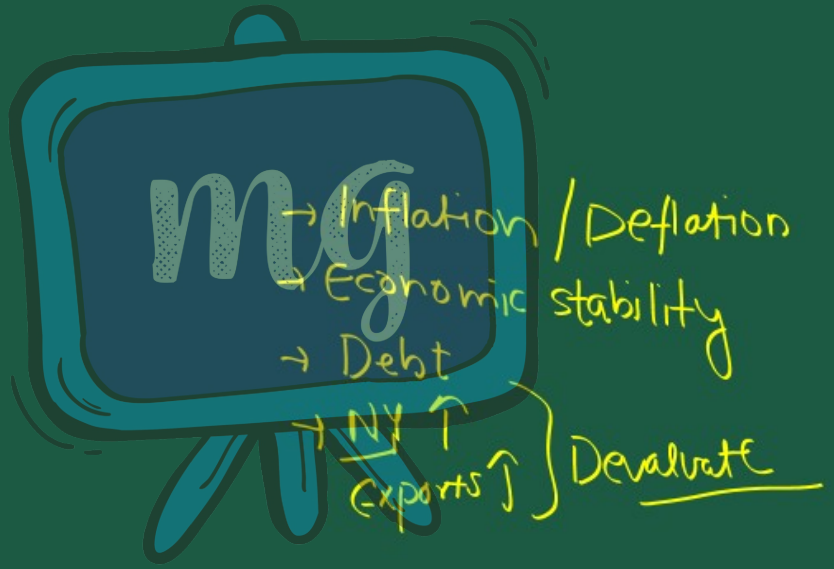

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DEVALUATION VS DEPRECIATION

Basis	Devaluation	Depreciation
Meaning	Reduction in price of domestic currency in terms of all foreign currencies under fixed exchange rate regime.	Fall in price of domestic currency in terms of a foreign currency under flexible exchange rate regime.
Occurrence	Done by Government intervention	Determined by market forces

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REVALUATION VS APPRECIATION

Basis	Revaluation	Appreciation
Meaning	Increase in the value of Domestic currency in terms of Foreign Currency under fixed exchange rate regime.	Increase in the value of Domestic currency in terms of Foreign Currency under Flexible Exchange rate regime.
Occurrence	By the Government Intervention.	By the Free Market Forces.

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DETERMINATION OF EXCHANGE RATE



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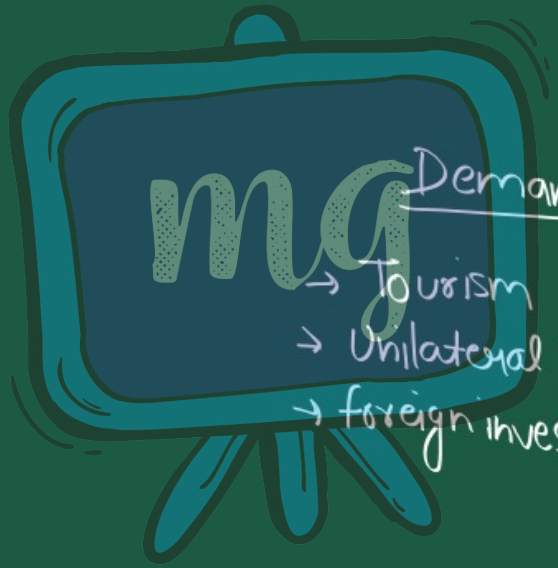

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DEMAND OF FOREIGN EXCHANGE

Comes from people who need to make payments in Foreign Currency.



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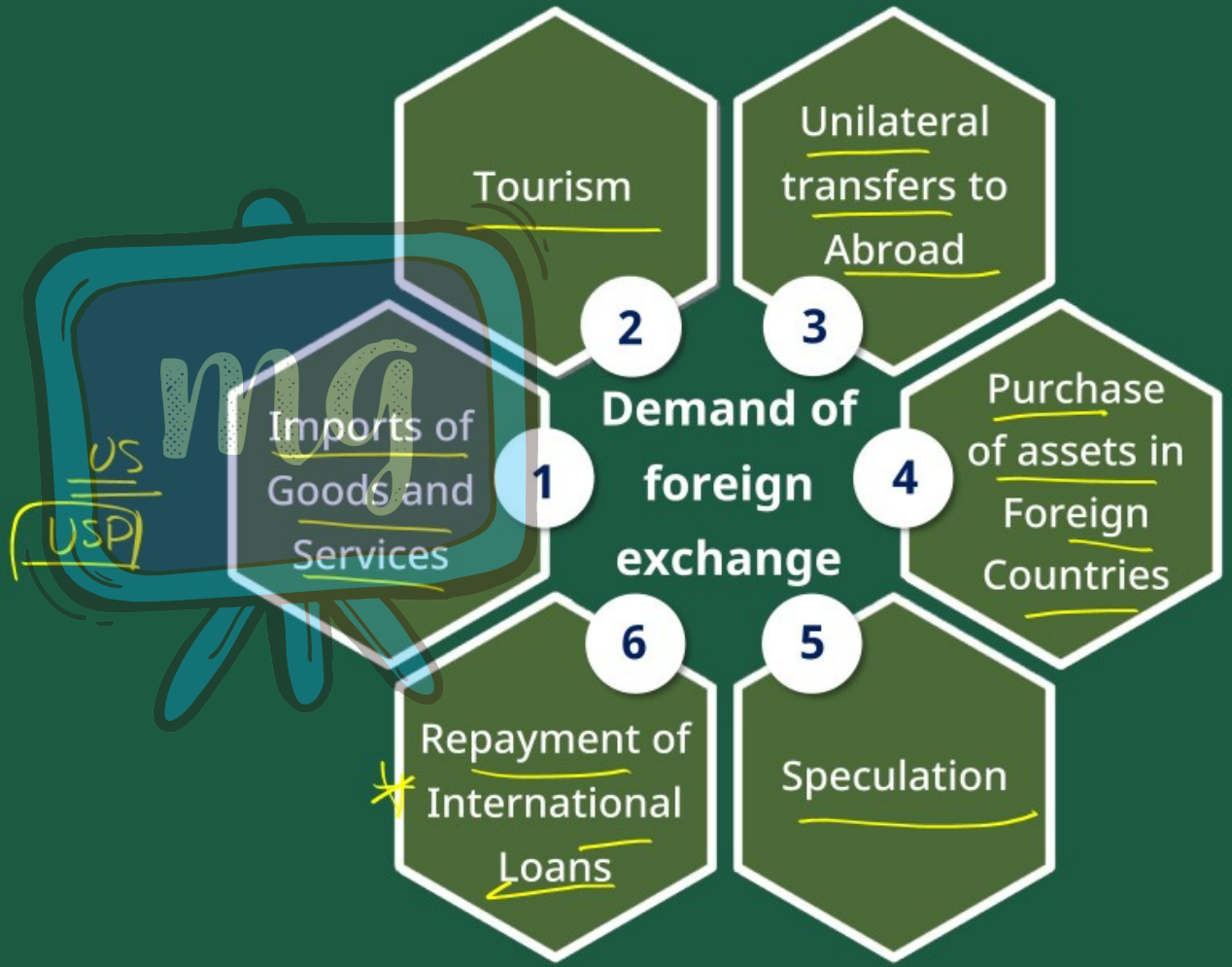

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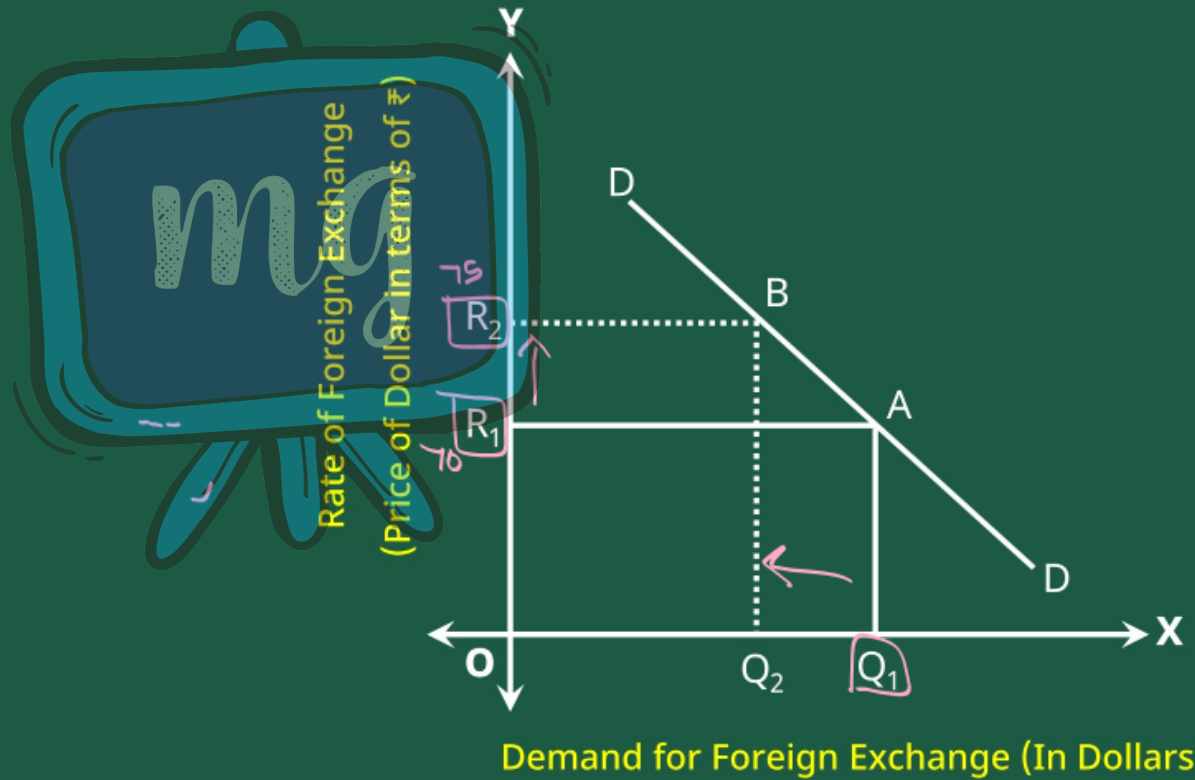
Demand Curve of Foreign Exchange



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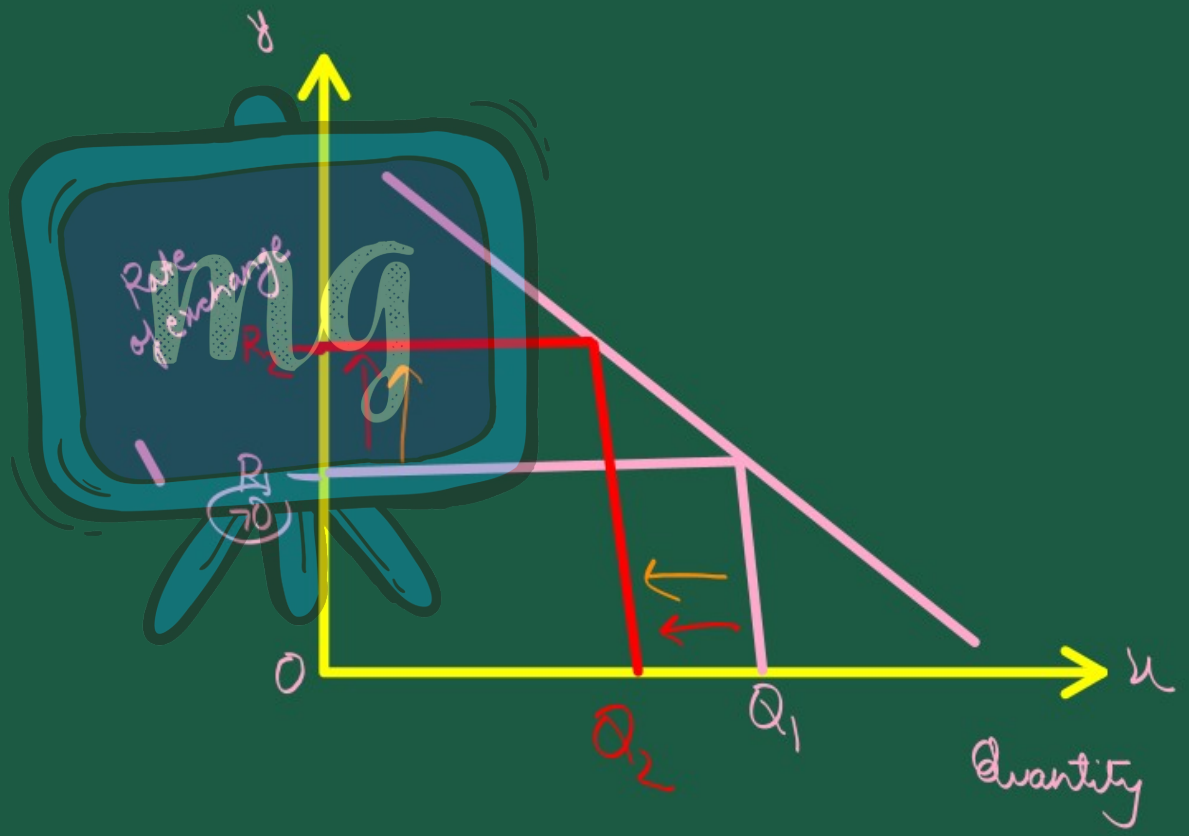

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- The negatively sloped demand curve (DD) shows that more foreign exchange (OQ_1) is demanded at a low rate of exchange (OR_1).
- Demand for US dollars falls to OQ_2, when the exchange rate rises to OR_2.

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SUPPLY OF FOREIGN EXCHANGE

Comes from transaction that involves receipts of Foreign Currency.



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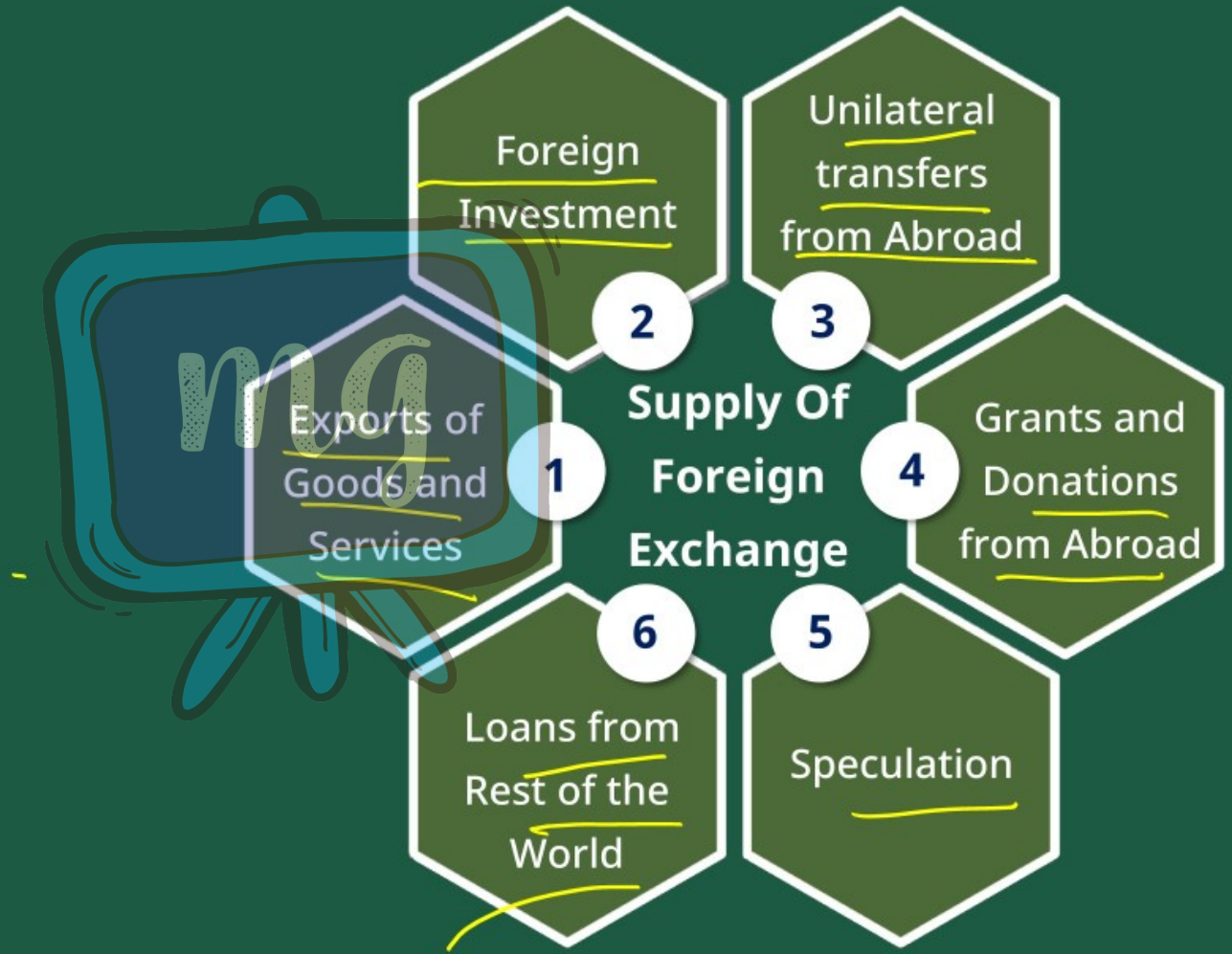

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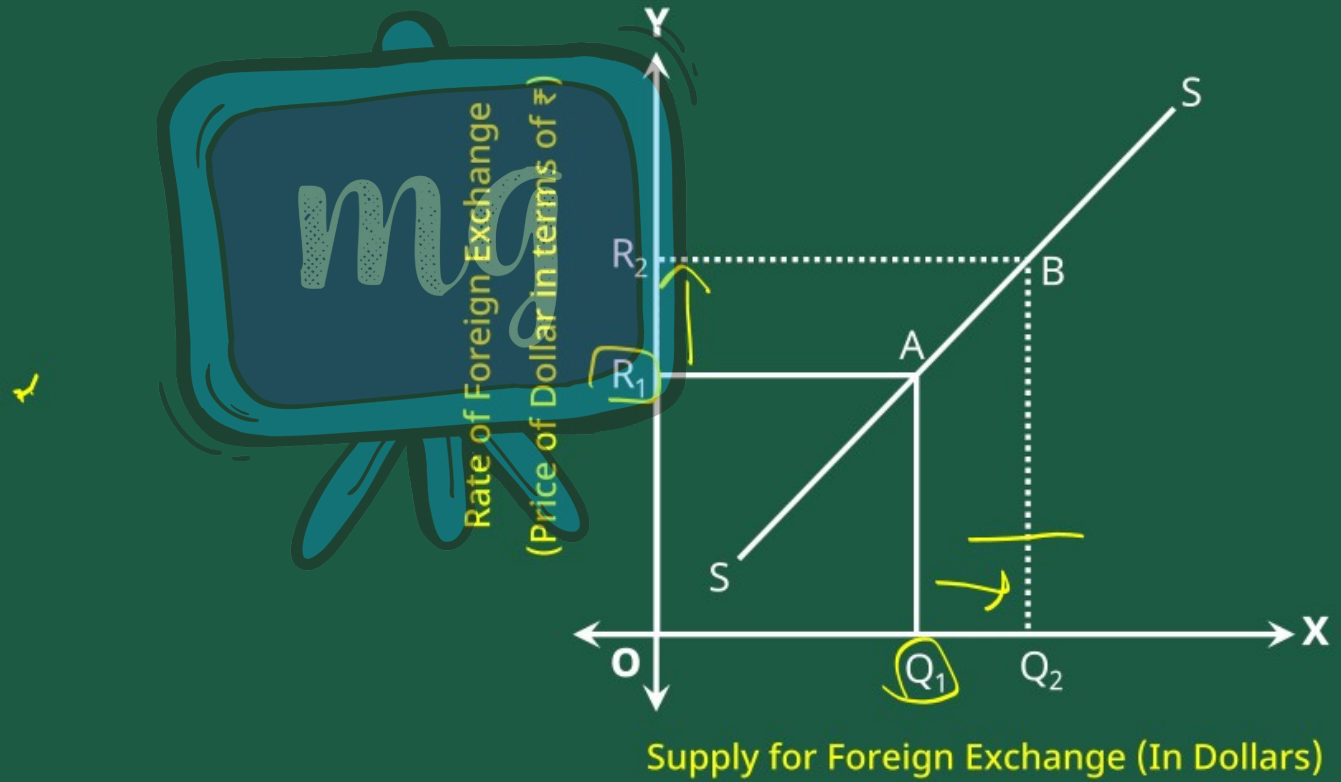
Supply Curve of Foreign Exchange



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- The positively sloped supply curve (SS) shows that supply of foreign exchange rises from OQ_1 to OQ_2 when the exchange rate rises from OR_1 to OR_2.



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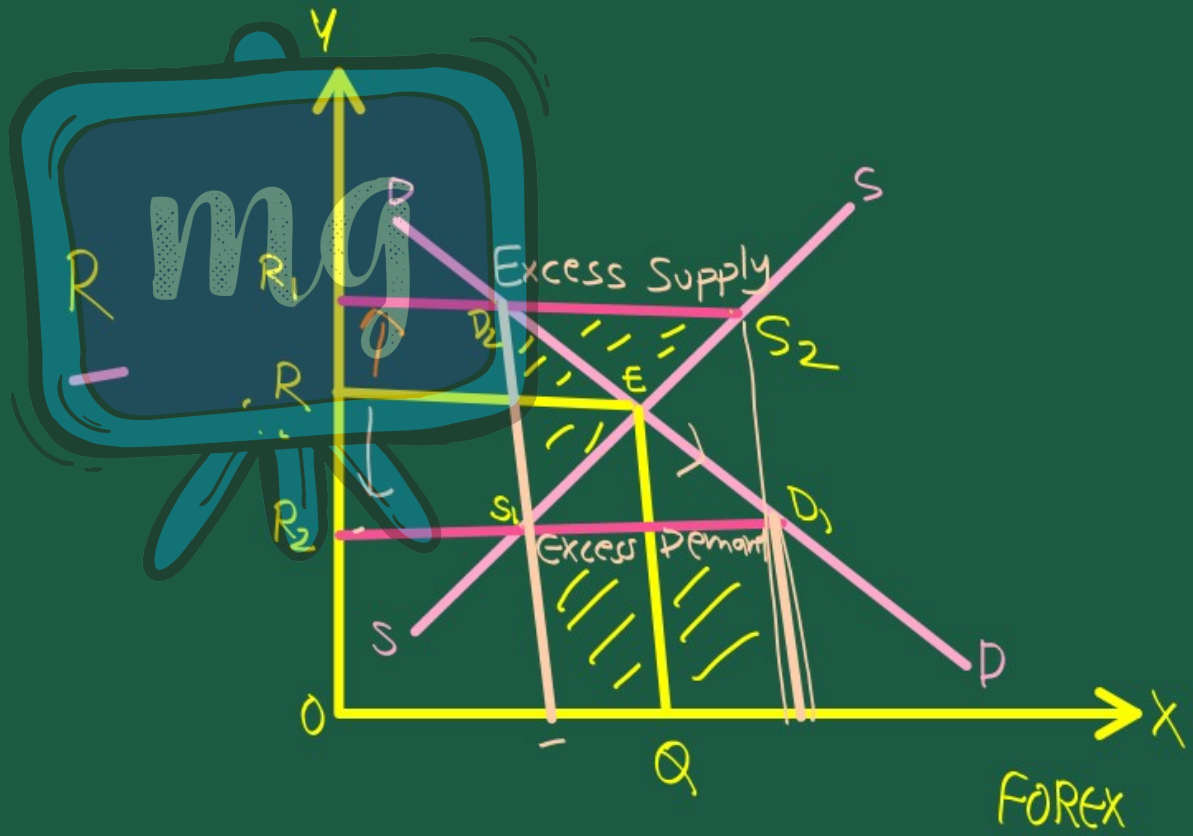

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DETERMINATION OF EXCHANGE RATE

In Flexible Exchange Rate system, Equilibrium Exchange rate is determined by the demand and supply of the currencies.



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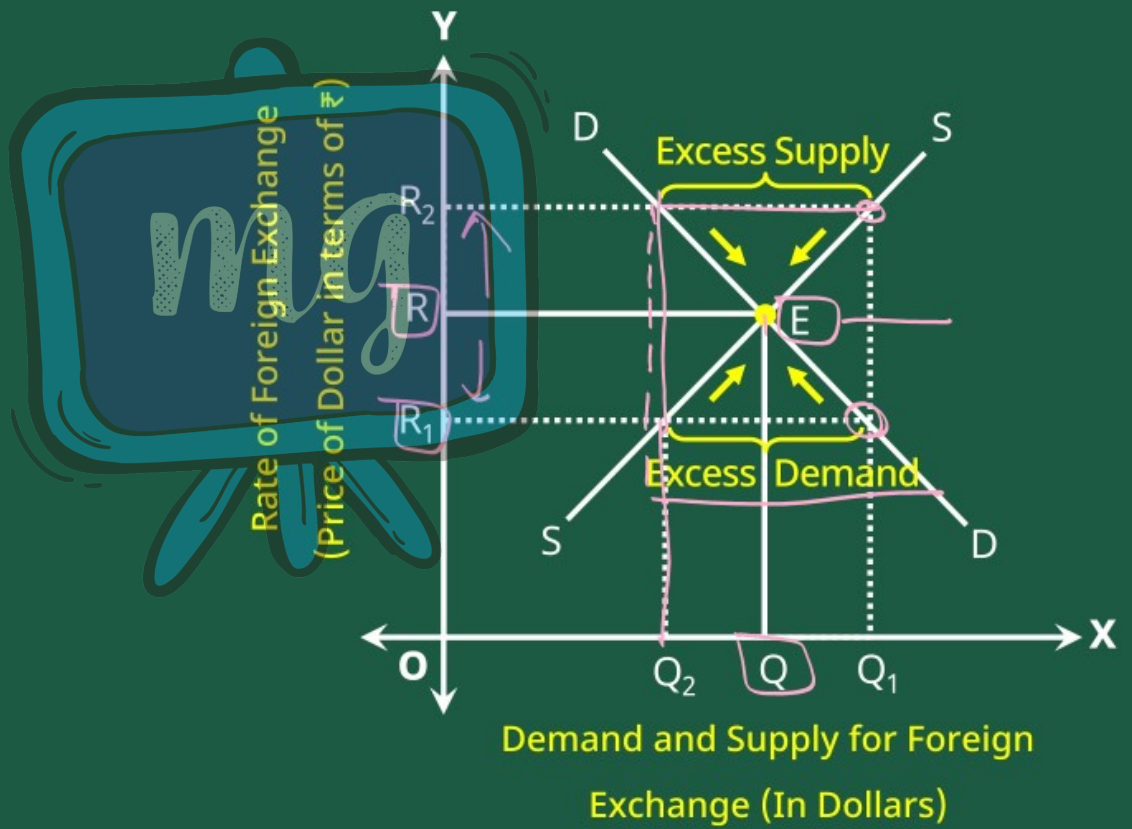
Determination of Equilibrium Exchange Rate



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LEARNING OUTCOMES

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1. Determination of Exchange rate
2. Concept of Devaluation and Revaluation



1 If a country experiences an increase in exports, what is the likely impact on the demand for its currency in the foreign exchange market?

A Depreciation of Currency

B Appreciation of currency

C Constant currency

D None of the above



2 Which of the following is a consequence of devaluation of a country's currency?

A Increase in exports

B Decrease in imports

C Increase in foreign investment

D Decrease in inflation



3 Appreciation of a currency makes –

A Exports cheaper

B Imports cheaper

C Both A and B

D None of the above