SHETH NKTT COLLEGE OF COMERCE AND SHETH JTT COLLEGE OF ARTS, THANE

DEPARTMENT OF ECONOMICS

QUESTION BANK & MODEL ANSWER

FOR

TYBCOM (2019-20)

SEMESTER – VI

Note: These notes are brief notes and not an explanatory answer, students will have to explain the points in detail. Manan Prakashan's book on the syllabus is referred.

MODULE – IV: FOREIGN EXCHANGE MARKET

Questions with brief model answers.

1. What is foreign exchange market? discuss its functions.

Ans: FEM is an organizational setting within which individuals, business units, governments and banks buy and sell foreign currencies.it is a worldwide market which operates round the clock.

Participants in FEM: Retail Clients comprising of people, international investors, multinational corporations and others who need foreign exchange. Commercial banks, foreign exchange dealers such as, banks, investment firms and brokers are also the participants in FEM.

Functions of FEM:

i. Transfer of purchasing power
ii. Provision of credit instruments and credit
iii. Coverage of risk

2. **Explain how equilibrium exchange rate is determined**.

Ans: [**Note**: Draw diagram of demand and supply of Foreign Exchange and of the equilibrium.]

Rate of exchange is its price in terms of another currency, or a group of other currencies. Equilibrium exchange rate is determined by the interaction of demand for and supply of foreign exchange. The rate of exchange of a currency is said to be in equilibrium if there is no excess supply of or demand for it in the foreign exchange market. the demand for and supply of foreign exchange influence the equilibrium exchange rate.

a. Demand for Foreign Exchange:
   i. Import of goods
   ii. Import of services
   iii. Unilateral payments
   iv. Export of capital
   v. Future expectations
b. Supply of Foreign Exchange:

i. Export of goods
ii. Export of services
iii. Unilateral receipts
iv. Import of capital
v. Future expectations

3. Examine the Purchasing Power Parity theory.

Ans:

A. PPP theory explains the determination of **long-term equilibrium exchange rates** based on relative prices in two countries. It is based on Law of One Price. Which means that in the absence of transaction costs and official trade barriers, identical goods will have the same price in different markets when the prices are expressed in the same currency.
B. **The basic idea** of PPP theory is that foreign exchange is demanded by the people of a country because it has the power to command goods in the foreign country. Thus, there is an exchange of domestic purchasing power to foreign purchasing power.
C. The theory states that the rate of exchange between two currencies will be in **equilibrium** when it equals the ratio of price levels in the two countries expressed in terms of their respective currencies. The rate of exchange between the currencies of two countries is determined by their relative price levels.
D. **Assumptions of PPP theory**:

i. Absence of trade barriers
ii. Price index for each of the two countries must comprise the same basket of goods
iii. Homogeneous goods
iv. All the prices are indicated in the same year
v. Law of One-Price prevails

E. Two versions of PPP theory:

i. **The absolute version:** according to this version, the identical basket of goods in two different countries must sell for the same price when expressed in the same currency.

Criticism-

a. It is widely accepted purchasing powers can not be measured in absolute terms.
b. The goods produced in two countries cannot be homogeneous.
c. The selection of basket of goods may not be done objectively.
d. It is difficult to compile price indices.
e. There is no direct link between purchasing powers and exchange rates.
f. Capital account transactions cannot be considered while determining exchange rates.

ii. **The relative version:** it is presented by **Cassel** as a means for measuring changes in equilibrium exchange rate. As compared to the absolute version, it brings out the relationship between changes in internal purchasing power and changes exchanges rates. It states that changes in the equilibrium rate of exchange between two currencies will be governed by the changes in the ratio of their respective purchasing powers.

Criticism-

i. No free trade for few countries.
ii. It is difficult to determine the base year to determine the exchange rate.
iii. It is difficult to take two periods with same economic conditions in the trading countries to determine purchasing powers of them.
iv. The theory considers only few goods, whereas the price indices are prepared considering all the goods produced in the country.
v. It is difficult to have same basket of goods for two countries.
vi. Prices of different commodities are determined in different ways; it is not uniformly done. Besides which price indices to be considered is not mentioned in the theory.

4. **Distinguish between Spot and Forward exchange rates.**

Ans: Note: refer to concepts given below

5. **Explain the role of central bank in foreign exchange rate management.**

Ans: The role of central bank in Foreign Exchange Rate Management.

Unlike the earlier systems, at present the central bank can influence the exchange rate

i. By bringing a change in demand and supply of foreign exchange.
ii. By changing the rate of interest.
iii. By restricting the use of foreign exchange.

Role of central bank under Managed Float:

i. Reasons for Central Bank's intervention:
   a. Ability to produce a more appropriate rate
   b. To mitigate costs of overvalued or undervalued exchange rates
   c. To smoothen the economic adjustment process
   d. To protect domestic industries
   e. Sterilized and unsterilized intervention.

6. **Discuss Managed Flexible Exchange rate system**.

Ans: under flexible exchange rate system exchange rate is determined in the market by the forces of demand and supply of foreign exchange. Whereas under managed flexible exchange rate system, the central bank intervenes in the spot and forward foreign exchange market on a selective basis.

i. Reasons for Central Bank's intervention:
   a. Ability to produce a more appropriate rate
   b. To mitigate costs of overvalued or undervalued exchange rates
   c. To smoothen the economic adjustment process
   d. To protect domestic industries
   e. Sterilized and unsterilized intervention.

7. **Write note on:**

i. **Arbitrage**:

Ans: it is a process through arbitrageurs, usually banks who intend to make a riskless profit out of discrepancies between interest rate and the forward discount and forward premium. Arbitrageurs enter into arbitrage, that is, to purchase of an asset in a low-price market and its riskless sale in a higher price market. This process leads to equalization of prices of an asset in all the segments of the market. Arbitrageurs will take advantage of the different exchange rates prevailing in various foreign exchange markets due to interest rate differentials.

For example: $ = Rs. 70 in India and in USA $ = Rs. 68, people will buy dollars in USA and sell in India earning a profit of Rs. 2 per dollar. This leads to increase in demand for dollar and it will push up the prices of dollar to Rs. 69 and more supply of dollars in USA will bring down the price of dollar in India to Rs. 69, arbitrage helps to equalizes the exchange rate in different markets.

ii. Managed exchange rate system in India.

Ans: RBI intervenes as and when necessary to maintain orderly condition and curb excessive volatility in the foreign exchange market. Direct and indirect interventions: RBI has developed mechanisms for both direct and indirect intervention in the foreign exchange market to prevent volatility. Direct intervention is done by purchase and sale of US dollars in the spot and forward markets. To prevent the depreciation of rupee the RBI sells US dollars and buys dollars to appreciate rupee.

Concepts:

a. **Spot exchange rate:** it is the current exchange rate between the two currencies. It is determined by the market forces (demand and supply of foreign exchange). The basic principle of it is that it can be analyzed like any other price with the help of demand and supply forces. It is the rate at which immediate delivery of foreign exchange is made. Spot rate refers to the current exchange rate which may change many times during the day. Spot date on the other hand refers to the delivery date of currency. It is the settlement date on which date actual exchange of currencies take place. Spot exchange rates are determined in gigantic global interbank foreign exchange market. the banks are linked together by telephone, telex and satellite communications network called the Society for Worldwide International Financial Telecommunications (SWIFT).
b. **Forward Exchange Rate:** it is the rate at which the foreign exchange market makes the purchase or sale of foreign exchange agreed on currently for delivery and payment at affixed date in the future. These contacts usually have maturities of 30, 60 or 90 days. There are transactions for 180 and 360 days also. Importers who require to make a payment after 90 days or else will enter into an agreement to purchase foreign currency at a plus or minus rate than the spot rate.
c. **Hedging:** it is undertaken by hedgers which is an operation to protect themselves against the risk arising out of exchange rate changes. For example, an Indian importer who imports

goods from USA worth 50000 dollars and must make the payments in three months' time. The spot rate now is Rs. 70 for one dollar which requires Rs. 35000. Due to uncertainty of the market, if the importer fears a depreciation of rupee, he will have to pay more than Rs 70 for one dollar. Therefore, he may enter into buying dollar forward today through an agreement with commercial banks or authorized agents. Hedging helps firms cover the risk arising out of changes in exchange rates.

d. **Speculation:** speculators are the agents who speculate, i.e. purchase or sell foreign exchange with the intention of making a profit by taking the advantage of changes in exchange rates. They participate in forward exchange market by entering foreign exchange deal. Further speculators try to minimize their loss by entering into spot and forward arrangements simultaneously (Swaps).

Please Note: the above mentioned are not detailed answers, the students have to explain all the terms and their significance in detail manner as per marks assigned for the question during examination.

Also refer to the class notes given at the time of lectures.