**TY SEM – VI**

**MODULE IV**

INSTRUCTIONS: Given below are statements that are TRUE. Study them well along with those given in the book. They can be asked in some form or the other for MCQ’s and True / False.

PLEASE REFER TO BOTH **MANAN PRAKASHAN** AS WELL AS **SHETH PUBLICATION** FOR PRACTISING MCQs. Both are available in the library.

**Ch: 11 Foreign Exchange Market**

* Arrangement wherein entities indulge in purchase and sale of foreign currencies- Foreign exchange market
* Foreign exchange rate is determined by demand for and supply of foreign exchange
* A standard currency which is used to quote exchange rates of different currencies is called vehicle currency. Eg: US $
* Retail clients like individuals, investors, MNCs deal in foreign exchange market through commercial banks and authorized agents.
* Buying price- bid rate
* Selling price- ask rate
* Difference between bid and ask- spread
* Custodian of foreign exchange reserves- Central Bank of a country
* Wholesale market for foreign currency is also called interbank market
* Foreign exchange market helps to transfer purchasing power between people in different nations
* Current exchange rate between 2 currencies- spot exchange rate
* Delivery date of currency- spot date- 2nd working day after the day of settlement
* Spot transactions account for more than two-thirds of all business transacted in the foreign exchange market
* Spot rate is determined through demand and supply of foreign exchange
* Forward exchange rate is quoted when purchase or sale of foreign exchange is agreed upon today for delivery and payment in the future
* Forward exchange rate can either be at a premium or discount
* Process through which foreign exchange market participants aim to make a riskless profit due to rate variations- arbitrage
* Arbitrage- purchase of asset in a market where price is low in order to sell in a market where price is high
* Relationship between interest rate and inflation rate is given by – Irving Fisher. Fisher Effect
* Relationship between interest rate and exchange rate through inflation- international Fisher effect
* In uncovered arbitrage the investor doesn’t cover foreign exchange risk through forward contract
* An operation to protect the foreign exchange market participants against the risk arising out of exchange rate fluctuations- hedging
* Hedging makes use of the forward contract to protect against exchange rate changes
* Foreign exchange market participants who purchase and sell foreign exchange with the intention of making a profit due to the exchange rate fluctuations- speculators
* Speculators try to minimize their losses by entering into swap arrangements i.e. spot and forward contracts simultaneously
* The scope for speculation is high in a flexible exchange rate system and limited in a fixed exchange rate regime

**Ch: 12 Determination of equilibrium rate of exchange**

* Exchange rate- price of one currency in terms of another. It’s a measure of purchasing power and external value of the currency
* Equilibrium exchange rate- demand for foreign currency= supply of foreign currency
* Due to globalization and lowering of trade barriers, there is a significant increase in the import of goods and services thereby increasing demand for foreign exchange
* Inverse relation between price of imports and demand for foreign exchange
* Elasticity of demand for imports affect foreign exchange demand
* high demand for foreign exchange for a relatively inelastic demand for imports
* Future expectations of exchange rate leads to increase in foreign exchange demand by hedgers, speculators
* Supply of foreign exchange is influenced by price and volume of a country’s exports
* Supply for foreign exchange will be large if demand for a country’s exports are relatively inelastic
* An increase in supply of foreign currency will cause appreciation of domestic currency
* A fall in supply of foreign currency will cause depreciation of domestic currency
* An increase in demand of foreign currency will cause depreciation of domestic currency
* A fall in demand for foreign currency will cause appreciation of domestic currency

**Ch: 13 Purchasing Power Parity theory**

* After World War I the Gold Standard system was replaced by the paper standard
* PPP Theory was developed by Gustav Cassel
* PPP Theory is based on the Law of One Price- identical goods should have the same price in different markets
* The main factor determining exchange rate is the relative purchasing power of 2 currencies
* Equilibrium exchange rate is such that the exchange of currencies involves the exchange of equal amounts of purchasing power
* PPP theory assumes free trade
* Absolute version- identical basket of goods should sell for same price in different countries when expressed in the same currency
* Rate of exchange is determined by relative price levels in 2 countries
* Relative purchasing power (ability of the currency to purchase goods and services) is the primary factor in determining exchange rate
* Absolute version doesn’t consider the difference in quality of goods and services in different countries
* Doesn’t consider capital account transactions
* Relative version deals with measuring the changes in exchange rate
* Relative version- changes in equilibrium exchange rate is governed by changes in ratio of purchasing power of 2 countries
* A change in internal purchasing power of the country will cause the equilibrium exchange rate to change

**Ch: 14 Role of Central Bank in Foreign Exchange Rate Management**

* Exchange rate determined by the gold content in currencies- Mint par of exchange
* Under the IMF/ Bretton Woods system, exchange rate was fixed at $35 per ounce of gold
* Floating exchange rate emerged since 1973
* Under fixed exchange rate the Central Bank influences the exchange rate by purchasing and selling foreign exchange thereby affecting the demand and supply of foreign currency
* Central Bank can purchase or sell foreign currency to enhance or prevent appreciation and depreciation of domestic currency
* Central Bank purchases foreign currency to prevent appreciation of domestic currency
* Central Bank influences supply of domestic currency through open market operations- sterilized intervention
* India followed Bretton woods system after independence
* Under IMF standard the rupee was pegged to pound sterling
* Rupee was delinked from pound sterling in Sept 1975
* Rupee was devalued in 2 stages after 1991
* RBI is the regulator-cum-facilitator in India’s foreign exchange market
* LERMS was introduced from 1992
* Full convertibility of the rupee in the current account was introduced in 1994
* India has introduced partial convertibility on capital account
* India follows a managed flexible exchange system
* RBI intervenes directly in forex market by purchase and sale of foreign currency in spot and forward market
* RBI intervenes indirectly in forex market by regulatory action