Unit -3

Foreign exchange market and exchange rates

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1. **Explain how Exchange rate is determined in a foreign exchange market.**

   Ans: International currency exchange rates display how much one unit of a currency can be exchanged for another currency. Currency exchange rates can be floating, in which case they change continually based on a multitude of factors, or they can be pegged (or fixed) to another currency. A floating rate is determined by the open market through supply and demand on global foreign exchange markets. In a system of floating or flexible exchange rate, the spot exchange rate is determined by the forces of demand and supply in the international market.

   Let us assume a foreign exchange market with two countries ***A(Home Country)*** and ***B(Foreign Country)***. And the exchange rate of their currencies ***a*** and ***b*** to be finalized. Presently there is floating or flexible exchange regime in both A and B. Therefore, the value of currency of each country in terms of the other currency depends upon the demand for and supply of their currencies.

   DEMAND FOR FOREIGN EXCHANGE:

   The demand for foreign currency i.e. the currency of B in Country A arises due to the following factors.

   a) To purchase abroad goods and services by domestic residents of A.
   b) To purchase assets abroad or country B.
   c) To send gifts abroad.
   d) To invest directly in shops, factories in the foreign country.
   e) To undertake foreign tours.
   f) To make payment of international trade with country B.

SUPPLY OF FORIGN EXCHANGE:

The supply of foreign exchange to country A i.e. currency of B to contry A comes from the following sources.

a) When foreigners purchase home country's (Country A) goods and services through our exports

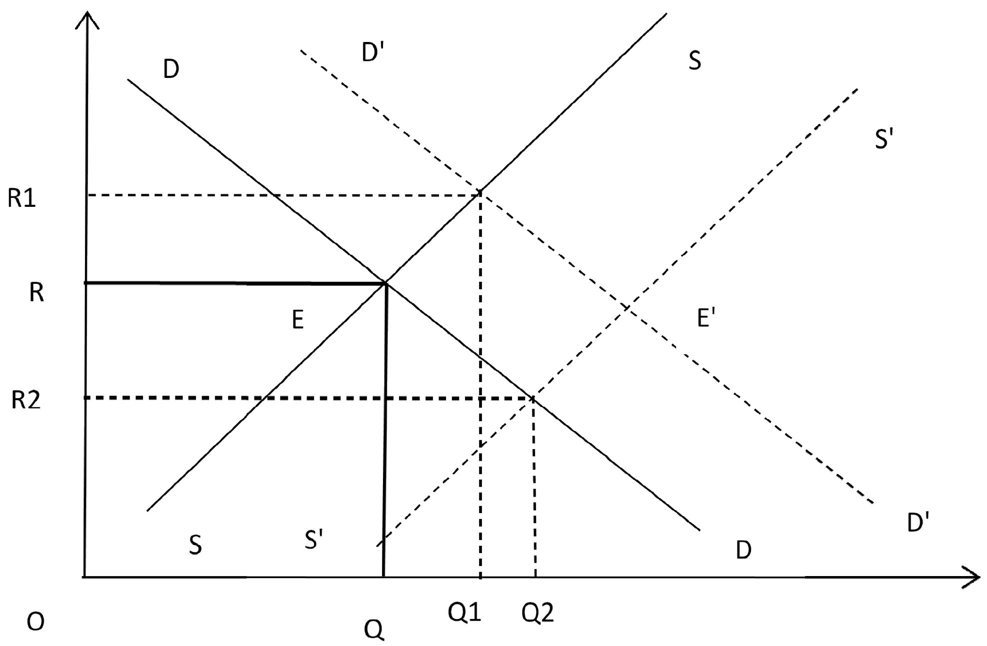
b) When foreigners make direct investment in bonds and equity shares of Country A.

c) When speculation causes inflow of foreign exchange
d) When foreign tourists come to home country

DETERMINATION OF FOREIGN EXCHANGE RATE:

The spot exchange rate in a foreign exchange market is determined at the point of equality of the Demand and Supply of foreign exchange at a particular time. At any particular time, the rate of foreign exchange must be such at which quantity demanded of foreign currency is equal to quantity supplied of that currency.

Graphically the Spot Exchange rate is determined at the point of Intersection of the Demand and Supply curve of foreign exchange of a particular country. This is explained with the help of the following diagram.



Determination of Spot Exchange Rate

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In the above diagram the X axis measures quantity demanded or supplied of foreign exchange (i.e., ***b***, Currency of Country B).On the other hand the rate of foreign exchange is measured along the Y axis. DD`is the demand curve of foreign exchange for country A (i.e Demand for ***b*** in country A) which shows that less foreign exchange is demanded when exchange rate increases. The reason is that rise in the price of foreign exchange increases the cost of foreign goods in country A which makes them more expensive. The result is fall in imports and demand for foreign exchange in country A.

SS` is the supply curve of foreign exchange (i.e. Currency of B) which implies that supply of foreign exchange increases as the exchange rate increases. This is because Country A's goods become cheaper to foreigners because its currency ***a*** is depreciating in value in terms of ***b.*** As a result, demand for A's goods increases. Thus, exports of A should increase as the exchange rate increases. This will bring greater supply of foreign exchange i.e ***b***. Hence, the supply of foreign exchange increases as the exchange rate increases .

In the diagram demand and supply curves of ***b*** intersect each other at point E which implies that at exchange rate of OR (QE), quantity demanded and supplied are equal .Hence, equilibrium exchange rate is OR and equilibrium quantity is OQ.

Thus the Spot exchange rate in a foreign Exchange Market is determined by the forces of demand and supply. On the other hand Forward Exchange is determined by contracts based on the current Spot exchange rate.