INDIAN SCHOOL AL WADI AL KABIR

Class: XII	Department:Commerce
	Topic: Open Economy

Short Answer Type Questions (3-4 Marks)

Qn 1. State four sources of demand of foreign exchange.

Or
Give three reasons why people desire to have foreign exchange.
Or [CBSE 2005]
What are the sources of demand for foreign exchange?

Answer: The demand (or outflow) of foreign exchange comes from the people who need it to make payments in foreign currencies. It is demanded by the domestic residents for the following reasons:

1. **Imports of Goods and Services:** When India import goods and services, foreign exchange is demanded to make the payment for imports of goods and services.
2. **Tourism:** Foreign exchange is demanded to meet expenditure incurred in foreign tours.
3. **Unilateral Transfers sent abroad:** Foreign exchange is required for making unilateral transfers like sending gifts to other countries.
4. **Purchase of assets in foreign countries:** It is demanded to make payment for purchase of assets, like land, shares, bonds, etc. in foreign countries.

Qn 2. What are the functions of a foreign exchange market?
Answer:

1. Transfer Function: Transfer function refers to transferring of purchasing power among countries.
2. Credit Function: It implies provision of credit in terms of foreign exchange for the export and import of goods and services across different countries of the world.
3. Hedging Function: Hedging function pertains to protecting against foreign exchange risks where Hedging is an activity which is designed to minimize the risk of loss.

Qn 3. Why does demand for foreign exchange rise when its price falls?
Or [AI 2006, 08, 10] What are the reasons for 'Rise in Demand' for Foreign Currency?
Answer: The demand for foreign currency rises in the following situations:

1. When price of a foreign currency falls, imports from that, foreign, country become cheaper. So, imports increase and hence, the demand for foreign currency rises.

For example, if price of 1 US dollar falls from Rs 60 to T 55, then imports from The USA will increase as American goods will become relatively cheaper. It will raise the demand for US dollar.

2. When a foreign currency becomes cheaper in terms of the domestic currency, it promotes tourism to that country. As a result, demand for foreign currency rises.
3. When price of a foreign currency falls, its demand rises as more people want to make gains from speculative activities.

Qn 4. State four sources of supply of foreign exchange.[CBSE 2004, 05, 05C, 07, 10; AI 05] Or What are the sources for supply of foreign exchange?

Answer: The supply (inflow) of foreign exchange comes from the people who receive it due to the following reasons.

1. **Exports of goods and services**:Supply of foreign exchange comes through exports of goods and services.
2. **Foreign investment:** The amount, which foreigners invest in their home country, increases the supply of foreign exchange.
3. **Remittances (unilateral transfers) from abroad:** Supply of foreign exchange increases in the form of gifts and other remittances from abroad.
4. **Speculation:** Supply of foreign exchange comes from those who want to speculate on the value of foreign exchange.

Qn 5. What are the reasons of 'rise in supply' of foreign currency?
Or
Why does a rise in foreign exchange rate cause a rise in foreign exchange supply? [CBSE 2006, 08]
Or
When exchange rate of a foreign currency rises, its supply also rises. How? Explain. [CBSE 2008]

Answer: The supply of foreign currency rises in the following situations:

1. When price of a foreign currency rises, domestic goods become relatively cheaper. It induces the foreign country to increase their imports from the domestic country. As a result, supply of foreign currency rises. For example, if price of 1 US dollar rises from Rs 60 to Rs 65, then exports to USA will increase as Indian goods will become relatively cheaper. It will raise the supply of US dollars.
2. When price of a foreign currency rises,foreign direct investment (FDI) from rest of the world increases, which will increase the supply for foreign exchange.
3. When price of a foreign currency rises, also supply of foreign currency rises as people want to make gains from speculative activities.

Qn 6. Explain the effect of depreciation of domestic currency on exports.
[A7 2013 (Set I), Sample Paper 2013]

Answer: Depreciation of domestic currency means a fall in the price of domestic currency (say, rupee) in terms of a foreign currency (say, $). It means, with the same amount of dollars, more goods can be purchased from India, i.e., exports to USA will increase as they will become relatively cheaper.

Qn 7. Explain the effect of appreciation of domestic currency on imports.
[CBSE 2013 (Set I), Sample Paper 2013)]

Answer: Appreciation of domestic currency means a rise in the price of domestic currency (say, rupee) in terms of a foreign currency (say, $). Now, one rupee can be exchanged for more $, i.e., with the same amount of money, more goods can be purchased from the USA. It leads to increase in imports from the USA as American goods will become relatively cheaper.

Qn 8. What are the merits of fixed exchange rate system? [CBSE 2009]
Answer:

1. **Stability:** It ensures stability, in the international money market/ exchange market. Day to day fluctuations are avoided. It helps formulation of long term economic policies, particularly relating to exports and imports.
2. **Encourages international trade:** Fixed exchange rate system implies low risk and low uncertainty of future payments. It encourages international trade.
3. **Co-ordination of macro policies:**Fixed exchange rate helps co¬ordination of macro policies across different countries of the world. Long term economic policies can be drawn in the area of international trade and bilateral trade agreements.

II. True Or False (1 mark)

Are the following statements true or false? Give reasons.
Qn 1. An increase in demand for imported goods raises the supply for foreign exchange.
Answer: False. Supply of foreign exchange will decrease in order to make the payment for imported goods.

Qn 2. Depreciation of Indian rupees will occur when Rs. 55 have to be paid to exchange one US $ instead of present rate of Rs. 50/$.
Answer: True. In case of depreciation, more rupees have to be paid to exchange one US dollar, i.e., greater than Rs. 50/$.

Qn 3. Appreciation of domestic currency leads to rise in imports.
Answer: True. Appreciation of domestic currency makes foreign goods relatively cheaper, which leads to increase in imports.

Qn 4. Revaluation and appreciation of currency are one and the same thing.
Answer: False. Revaluation refers to increase in the value of domestic currency by the government under fixed exchange rate. On the other hand, currency appreciation refers to increase in the value of domestic currency in terms of foreign currency under flexible exchange rate system.

Qn 5. In spot market sale and purchase of foreign currency is settled on a specified future date.
Answer: False. In spot market sale and purchase of foreign currency is settled immediately.
NOTE: As per CBSE guidelines, no marks will be given if reason to the answer is not explained..

Qn 6. 'Devaluation and Depreciation of currency are one and the same thing'. Do you agree? How do they affect the exports of a country? [CBSE Sample Paper 2016] [3 Marks]
Answer:

1. Devaluation refers to reduction in price of domestic currency in terms of all foreign currencies under fixed exchange rate regime, i.e., (It takes place due to government) .
2. Depreciation refers to fall in market price of domestic currency in terms of a foreign currency under flexible exchange rate regime, i.e., (It takes place due to market forces of demand and supply)

3. Currency Depreciation and Currency Devaluation may result into increase in exports of the goods and services from the country since it would increase the global competiveness of the goods.

MCQ:

1. Price of one currency in relation to other currencies in the international exchange market is known as :
   a. Equilibrium rate
   b. Fixed exchange rate
   c. Exchange rate
   d. Flexible exchange rate
2. The rate which is determined by the government is known as:
   a. Flexible exchange rate
   b. Fixed exchange rate
   c. Floating exchange rate
   d. None of these
3. What is the relationship between demand for foreign exchange and exchange rate?
   a. Inverse
   b. Direct
   c. One to one
   d. No relationship
4. Direct foreign investment of an individual of the domestic country is a source of:
   a. Demand for foreign exchange
   b. Supply of foreign exchange
   c. Both(a) and (b)
   d. None of these

5. Due to depreciation of foreign currency, the supply of foreign currency in domestic economy will:
   a. Increase
   b. Not change
   c. Either increase or decrease
   d. Decrease

6. Dirty floating is related to:
   a. Fixed system of exchange rate
   b. Flexible system of exchange rate
   c. Both of these
   d. None of these

7. Current account records transactions relate to:
   a. Export and import of goods
   b. Non-factor and factor income
   c. Current transfers
   d. All of these

8. Which of the following items relate to bop on capital account?
    a. Foreign investment
    b. Loans
    c. NRI remittances
    d. All of these

9. Unilateral transfers are:
    a. One-sided payments
    b. Reciprocal payments
    c. Factor incomes
    d. All of these

10. Balance of trade is a part of:
    a. Current account bop
    b. Capital account bop
    c. Official reserves account
    d. None of these