ANS :I totally agree with the statement that exports are the good thing, whereas the imports are more like necessarily evil.What a country gains from international trade is the ability to import things it wants from other countries. Exporting is not a rational national objective in and of itself. The need to export is a burden that a country must bear because its import suppliers demand payment for what they supply. Suppose that the Nepal exported 10% of its national output and imported nothing. What would be the consequences? We would have for domestic use only 90% of what we produce, so we would have a lower standard of living than if we exported nothing.Would we get anything in exchange for our exports? We would get a lot of foreign money. But foreign money is generally of value only because it can be used to buy foreign goods and services. If we are not going to import, of what use is acquiring foreign money? We could, of course, use this money to make investments in foreign countries and these investments would undoubtedly yield profits (or at least interest) in the future. But this simply means that we would have more unusable foreign money in the future. Unless you are going to use acquired foreign money to buy things from other countries (i.e., to spend it on imports) now or in the future, there is not much point in exporting.Now suppose that the Nepal imported an amount of foreign goods and services equal to 10% of what we produce and exported nothing. What would be the consequences? We would have for domestic use 110% of what we produce, so we would have a higher standard of living than if we imported nothing. What would we give other countries in exchange for these imports? Nepali Rupees, of course. Although this loss is bad, in the long run, foreigners are going to spend the proceeds from their exporting to the Nepal on – Nepal goods and services (i.e., Nepal exports). This means that over the long haul international trade is pretty much a two-way street. If a county is going to be able to import, it is going to have to export and vice- versa. And over the long haul, the value of a country’s exports is going to be approximately equal to the value of its imports.

ANS :Wassily Leontief, a Russian-American economist made several contributions to the world of economics. One of his most renowned work is the study of trade flows in the 1950s. Based on input-output analysis of international trade he discovered that the U.S., a country with a great deal of capital abundant, was importing capital-intensive commodities and exporting labor-intensive commodities. This is in contrast to prior theories of international trade, which predict that countries will specialize in and export goods that they have a comparative advantage in (FACTOR OF PRODUCT) producing. This means that a capital rich country, such as the U.S., would be expected to export capital-intensive goods and import labor-intensive goods from countries where labor is comparatively cheaper.The Leontief Paradox, as it came to be known, led many economists to question the Heckscher-Ohlin Theorem, which states that countries produce and export what they can create most efficiently, depending on their factors of production. Moreover, they import goods that they cannot produce as efficiently. Several later economists proposed solutions to this apparent paradox, including the Linder Hypothesis and the Home Market Effect. Linder hypothesis explains that rich countries with larger demand for high-quality goods will tend to specialize in those goods and consequently will tend to trade more with other rich countries. While Home market effect (Home market demand) explains that countries with large consumption of a particular item will often run a trade surplus in that industry characterized by high economies of scale and high transportation cost, meaning that the production of high-economy-of-scale/high-transport-cost goods can be more efficiently done in geographic locations with high local demand, rather than high comparative advantage, whereas goods with weak economies of scale and/or low transport costs will tend to be produced by smaller countries (where lower wages tend to offset the other factors).Notably, Leontief's Paradox does not account for human capital and the resulting difference between skilled and unskilled labor. Later researchers showed that U.S. exports were skilled-labor-intensive—or, in other words, human capital intensive relative to imports—resolving the Leontief Paradox in favor of the comparative advantage view.

ANS :Economic growth is an increase in the production of goods and services over a specified time. In the long run a country can achieve economic growth from two sources.-When a country’s endowment of factors of production increase. Such factors of production can include land, labour and capital.-When country can improve its production technologies. Both these factors will raise the country abilities to produce goods and services and raise the productivity of a country and when the productivity of a country can be improve, the country is more likely to experience economic growth. However, increase in productivity may not imply that a country will always be able to experience economic growth because improvement in productivity also might actually cause the country to worsen. Balanced growth refers to a specific type of economic growth that is sustainable in the long term in which terms of trade remain unchanged despite the growth in production.Let’s consider a country Nepal before growth can produce 80 units of wheat and 20 units of cloth as denoted by point S1, the consumption is denoted at point C1 that means the country was consuming 40 units of wheat and 60 units of cloth. This means the country was exporting 40 units of wheat out of 80 unit produced. At the same time the country was importing 40 units of cloth as its production of cloth is only 20 units but the consumption was 60 units. Since 40 units of wheat were exported in in exchange of 40 units of cloth. The terms of trade was established at 1 unit of wheat exchanged for 1 unit of cloth.(Production, consumption, export, import and terms of trade). After growth, the PPC curve shifted outward and the country can produce 112 unit of wheat and 28 unit of cloth as denoted by point S2, the consumption is denoted at point C2 where the country is consuming 56 units of wheat and 84 units of cloth. This means the country is exporting 56 units of wheat as after growth it can produce 112 unit of wheat and consumes only 56 unit. At the same time the country is importing 56 units of cloth as after the growth the production of cloth increased by 28 units and the consumption also increased to 84 units. After growth the country is exporting 56 unit of wheat in exchange of 56 unit of cloth. This means that the terms of trade hasn’t changed because of this growth which is1 unit of wheat is equal to1 unit of cloth. In a balanced growth, the PPC curve shifts outward in the same proportion. The growth in country’s ability to produce will increase the production of both goods at a proportionate rate. Thus, the term of trade of a country will also remain unchanged, Balanced growth.

ANS :The Rybczynski Theorem (RT) says that if the endowment of some resource increases, the industry that uses that resource most intensively will increase its output while the other indus¬try will decrease its output. The relative factor intensity is measured by the ratio of factor use in each industry.The theorem suggests that unbalanced growth in factor supplies tends, at con¬stant commodity prices, to lead to strong asymmetric changes in output level of two types of industries-capital-intensive and labour-intensive. If the member of factors and commodities are evenly matched and two commodities (such as wheat and cloth) are not jointly produced, this asymmetry entails that growth in one factor, such as labour, acts as a force to cause an actual fall in the production of one commodity.Let us consider a country produces two products- wheat and cloth. Let’s consider wheat as a land intensive good and cloth as a labor intensive product. Let’s say before growth, a country is producing 120 units of wheat and 30 units of cloth. If a country endowment of labor increased with the increase in number of immigrants this will result in an increase in the quantity produced of the labor-intensive good i.e cloth, while cause decrease in the quantity produced of the other good i.e. wheat. The additional labor goes to work in the labor-intensive industry i.e cloth industry. But, to expand production of this cloth, extra non-labor resources (e.g., land) are needed to work with the extra labor. These extra non-labor resources are drawn from the other industry i.e wheat, so production of the wheat decreases.

ANS :Immiserizing growth is a theoretical situation first proposed by Jagdish Bhagwati, in 1958. It can be explained as an unbalanced growth where by a country that is very efficient at production of one good can increase its exports to achieve a level of growth but eventually will lead to a decline in terms of trade making the same country worse off than before the exports. This can occur due to the fact that the country is so efficient in its production or expands its willingness to trade that the product it makes drives down the global prices, as the quantity supplied is very high and the country deems to export more. On the other side, the imports for this country can be driven up with the shift to production of efficient goods only making a triple disadvantage for the country. All the forces combined this outweighs the benefits of the extra production capacity.A country whose trade has almost no impact on world prices is at great risk of immiserizing growth. This statement is indeed false. It can be explained well with the fact that immiserizing growth is only possible when a country is so efficient in its production or expands its willingness to trade that the product it makes drives down the global prices, as the quantity supplied is very high and the country deems to export more. However, if a country export level doesn’t influence the world price despite the increase supply which may be resulted due to the fact that the country is more likey a small one, with less economic influence and it’s increase production is comparatively smaller than the global demand, in such instinct immiserizing growth is far from taking place. And regarding the other side where by driven import of the country due to shift in production of efficient goods will now be balanced with the inclining export level and the inclined trade. All these forces combined will now lead to a balanced economic growth, balanced trade, balancing the extra production capacity influencing import level.Hence, If a country's trade has almost no impact on world prices, then its growth will have almost no impact on its terms of trade, and immiserizing growth is very unlikely. The theorem suggests that unbalanced growth in factor supplies tends, at con¬stant commodity prices, to lead to strong asymmetric changes in output level of two types of industries-capital-intensive and labour-intensive. If the member of factors and commodities are evenly matched and two commodities (such as wheat and cloth) are not jointly produced, this asymmetry entails that growth in one factor, such as labour, acts as a force to cause an actual fall in the production of one commodity.Let us consider a country produces two products- wheat and cloth. Let’s consider wheat as a land intensive good and cloth as a labor intensive product. Let’s say before growth, a country is producing 120 units of wheat and 30 units of cloth. If a country endowment of labor increased with the increase in number of immigrants this will result in an increase in the quantity produced of the labor-intensive good i.e cloth, while cause decrease in the quantity produced of the other good i.e. wheat. The additional labor goes to work in the labor-intensive industry i.e cloth industry. But, to expand production of this cloth, extra non-labor resources (e.g., land) are needed to work with the extra labor. These extra non-labor resources are drawn from the other industry i.e wheat, so production of the wheat decreases.

ANS :Let us first discuss the impact of tariff on production, consumption and revenue. Tarrif ( negatively impact Producer of exporting country, consumer of importing country, advantageous: Producer of importing country, consumer of exporting country).In diagram curves Dd and Sd are the domestic demand and supply curves for the particular good under consideration. In Isolation, production, consumption and commodity price are determined by their intersection at the point E.Under free trade conditions, however, the foreign supply here assumed to be perfectly elastic, must be added to the domestic supply resulting in the overall supply curve Sd + Sf. Equilibrium is now at point F with quantity OQ2 being consumed at price P1 of which OQ1 is produced at home and rest Q1Q2 imported. Now on adding tariff T, is applied, which raise the free trade supply curve (assuming foreign prices remain unchanged as a result), by Sd + Sf + T.Equilibrium now shifts to point G. As a result of the tariff, the domestic price has gone up to P2 causing a reduction of consumption to OQ4. At the same time, the higher prices have encouraged domestic supplies to expand output to OQ3, so that imports are reduced from Q1Q2 to Q3Q4. Without the tariff, total consumer surplus is represented as the area NP1F. With the tariff, it is reduced to NP2G for an overall consumer surplus loss of P1P2GF. This loss to consumer is absorbed in a number of ways.The tariff makes it possible for the government to collect revenues from the import duty. Tariff revenues always equal the amount of duty times the quantity of goods imported under it. Hence, here the revenue collected equals P1P2 X Q3Q4, the area (r) in the figure. This represents that part of the loss in consumer surplus which is transferred to the government in the form of money, the revenue effect a tariff.

ANS :A quota is a quantitative limit through imports. In diagram curves Dd and Sd are the domestic demand and supply curves for the particular good under consideration. In Isolation, production, consumption and commodity price are determined by their intersection at the point E. Under free trade conditions, however, the foreign supply here assumed to be perfectly elastic, must be added to the domestic supply resulting in the overall supply curve Sd + Sf. Equilibrium is now at point F with quantity OQ2 being consumed at price P1 of which OQ1 is produced at home and rest Q1Q2 imported. Now on adding quota T, is applied, which raise the free trade supply curve (assuming foreign prices remain unchanged as a result), by Sd + Sf +T. Equilibrium now shifts to point G. As a result of the quota Q3Q4, the domestic price has gone up to P2 causing a reduction of consumption to OQ4. At the same time, the higher prices have encouraged domestic supplies to expand output to OQ3, so that imports are reduced from Q1Q2 to Q3Q4. Without the Quota, total consumer surplus is represented as the area NP1F. With the quota, it is reduced to NP2G for an overall consumer surplus loss of P1P2GF. This loss to consumer is absorbed in a number of ways. The Quota revenue benefits the lucky importers who manage to get the scarce and valuable import permits and if import licenses are auc¬tioned off to the importers then government would earn revenue. Here, quota revenue equals P1P2XQ3Q4, the area (r) in the figure. This represents that part of the loss in consumer surplus which is transferred to the government or Lucky importers in the form of money, the revenue effect of quota.

ANS :Import quotas are government-imposed limits on the quantity of a certain good that can be imported into a country. Generally speaking, such quotas are put in place to protect domestic industries and vulnerable producers. Quotas prevent a country’s domestic market from becoming flooded with foreign goods, which are often cheaper due to lower production costs overseas. Absolute quota – a simple physical limit on the number. Tariff rate quota – These allow a certain number of imports to gain a discount on the usual tariff rate. Voluntary export restraints (VER) this is when a government limits the amounts of exports from one country to another for a particular type of good.Quotas and tariffs are both used to protect domestic industries by artificially raising prices in the domestic market. Their administration and effects, however, differ in specific ways. Quotas restrict the quantity of a good imported from another country. Tariffs are a charge levied on the value of goods imported from another country. Although there are some similarities, like they both acts as a tool that seeks to control the international trade and encourage the production within the home country, for the purpose of making it, self-sufficient. Some governments use them instead of just using tariffs to restrict imports by the same amounts because Quotas will reduce imports, and help domestic suppliers. Quotas also will lead to lower sales for foreign companies, but it could push up prices and make sales more profitable. Government programs that implement quotas are often referred to as protectionism policies. Additionally, governments can enact these policies if they have concerns over the quality or safety of products arriving from other countries. Highly restrictive quotas coupled with high tariffs can lead to trade disputes, trade wars, and other problems between nations. For example, in January 2018, President Trump imposed 30% tariffs on imported solar panels from China. Quotas are more effective in restricting trade than tariffs, especially if domestic demand for something is not price-sensitive. Quotas may also be more disruptive to international trade than tariffs. Applied selectively to various countries, they can be utilized as a coercive economic weapon. Apart from protecting domestic industries, another purpose of import quotas is to save foreign exchange reserves and lessen pressure on the balance of payments. High imports put pressure on the trade balance. That can result in a deficit if exports don’t grow at an equal rate. A deficit means that the incoming currency is lower (proceeds from exports) than is exiting (to pay for imports). That ultimately drained foreign currency reserves to pay for imports.

ANS :The balance of payments (BOP) is the place where countries record their monetary transactions with the rest of the world. Examining the current account balance (CAB) of a country's BOP can provide a good idea of its economic activity. It includes activity around a country's industries, capital market, services, and the money entering the country from other governments or through remittances. The current account balance should theoretically be zero, which is impossible, so in reality, it will tell whether a country is in a surplus or deficit. A surplus is indicative of an economy that is a net creditor to the rest of the world. A deficit reflects a government and an economy that is a net debtor to the rest of the world.The four major components of a current account are:Goods: These are movable and physical in nature, and for a transaction to be recorded under "goods," a change of ownership from or to a resident (of the local country) to or from a non-resident (in a foreign country) has to take place. Movable goods include general merchandise, goods used for processing other goods, and non-monetary gold. An export is marked as a credit (money coming in), and an import is noted as a debit (money going out).Services :These transactions result from an intangible action, such as transportation, business services, tourism, royalties, or licensing. If money is being paid for a service, it is recorded as an import (a debit). If money is received, it is recorded as an export (credit).Income: Income is the money going in (credit) or out (debit) of a country from salaries, portfolio investments (in the form of dividends, for example), direct investments, or any other type of investment. Together, goods, services, and income provide an economy with fuel to function. This means that items under these categories are actual resources that are transferred to and from a country for economic production.Current Transfers: Current transfers are unilateral transfers with nothing received in return. These include workers' remittances, donations, aids and grants, official assistance, and pensions. Due to their nature, current transfers are not considered real resources that affect economic production.

ANS :The Balance of Payments (BOP) is a statement that tracks all monetary transactions between citizens of a nation and the rest of the globe during a specific time period. This statement covers all transactions made by/to people, corporations, and the government and aids in the monitoring of monies used to grow the economy. In an ideal situation, where all of the factors are accurately incorporated in the BOP, it should be zero. This means that money inflows and outflows should be balanced. However, in most circumstances, this does not occur optimally.A country's BOP statement reveals if the country has a fund surplus or deficit, i.e., when a country's export exceeds its import, its BOP is considered to be in surplus. The BOP deficit, on the other hand, implies that its imports exceed its exports.The BOP transaction tracking system is comparable to the double-entry accounting system. Every transaction will contain a debit entry and a credit entry.For Example; Foreign funds entering a country are classified as credit and documented in the BOP. In the BOP, outflows from a nation are reflected as debits. Assume Japan sends 100 vehicles to the United States. The export of the 100 automobiles is recorded as a negative in Japan's BOP, while the imports are recorded as a credit in the United States' BOP.A country’s BOP is vital for the following reasons:•A country's BOP indicates its financial and economic situation.•It also reveals whether the country produces enough economic output to pay for its growth.•A BOP statement can be used to evaluate if the value of a country's currency is increasing or decreasing.•The BOP statement aids the government in making fiscal and trade policy decisions.•It gives critical information for analysing and comprehending economic transactions with foreign countries.•It is also vital in identifying trends that may be beneficial or harmful to the county’s economy and, thus, then take appropriate measures.•It helps the government analyse a particular industry’s export growth potential and formulate policies to sustain it.•It gives the government a comprehensive perspective on a different range of import and export tariffs. The government then increases and decreases the tax to discourage imports and encourage export, individually, and self-sufficiency.

ANS :A deficit on the current account means that the value of imports is greater than the value of exports. A surplus on the current account means that the value of imports is less than the value of exports. A current account surplus is a positive current account balance, whereas a current account deficit is a negative current account balance. A current account surplus is partly due to high exports, but the other side of the equation is imports and domestic demand. A country may have a large current account surplus because of relatively weak domestic demand. This weak demand leads to lower consumer spending and lower spending on imports. A country may have large current account deficit due to overvaluation of currency, imports will be cheaper, and therefore there will be a higher quantity of imports. If there is an increase in national income, people will tend to have more disposable income to consume goods. If domestic producers cannot meet the domestic demand, consumers will have to import goods from abroad. Declining competiveness of exporting manufacture sector, recession, inflation are many more factor that causes current account deficit. Here, Transaction c contributes to a surplus in the current account which means the transaction whereby the United States sells a $100 million jet to Turkey, and Turkey pays by transferring the $100 million from its bank account to the U.S. seller because it is an export of merchandise that is paid for through an item in the financial account. Transaction a, in which Boeing barters a $100 million plane to Mexico in exchange for $100 million worth of hotel services on the Mexican coast doesn’t necessarily contribute in current account surplus since it leaves the current account unchanged because it is both an export and an import, hence doesn’t contribute neither in surplus of current account nor cause deficit of current account. Moreover transaction b which includes the United States borrowing $100 million long-term from Saudi Arabia to buy $100 million of Saudi oil this year is less likely to cause current account surplus and more likely contributes to a deficit in the current account because it is an import.Lastly Transaction d, where by a British investor buys $100 million of IBM bonds from the previous U.S. owner of these bonds, and the British buyer pays by transferring the $100 million from his bank account to the previous U.S. owner affects no items in the current account, hence doesn’t contribute neither in surplus of current account nor cause deficit of current account.

ANS :Devaluation is a downward adjustment to a country’s value of money relative to a foreign currency or standard. Many countries that operate using a fixed exchange rate tend to use devaluation as a monetary policy tool to control supply and demand.-Exports cheaper. A devaluation of the exchange rate will make exports more competitive and appear cheaper to foreigners. This will increase demand for exports. Also, after a devaluation, UK assets become more attractive; for example, a devaluation in the Pound can make UK property appear cheaper to foreigners.-Imports more expensive. A devaluation means imports, such as petrol, food and raw materials will become more expensive. This will reduce the demand for imports. It may also encourage British tourists to take a holiday in the UK, rather than the US – which now appears more expensive.-Increased aggregate demand (AD). A devaluation could cause higher economic growth. Part of AD is (X-M) therefore higher exports and lower imports should increase AD (assuming demand is relatively elastic). In normal circumstances, higher AD is likely to cause higher real GDP and inflation.-Inflation is likely to occur following a devaluation because:Imports are more expensive – causing cost push inflation.AD is increasing causing demand pull inflationWith exports becoming cheaper, manufacturers may have less incentive to cut costs and become more efficient. Therefore over time, costs may increase.-Improvement in the current account. With exports more competitive and imports more expensive, we should see higher exports and lower imports, which will reduce the current account deficit. In 2016, the UK had a near record current account deficit, so a devaluation is necessary to reduce the size of the deficit.-Wages. A devaluation in the Pound makes the UK less attractive for foreign workers. For example, with fall in the value of the Pound, migrant workers from Eastern Europe may prefer to work in Germany than the UK. In the UK food manufacturing industry, more than 30% of workers are from the EU. UK firms may have to push up wages to keep foreign labour. Similarly, it becomes more attractive for British workers to get a job in the US because a dollar wage will go further. (FT – migrants become more picky about UK jobs)-Falling real wages. In a period of stagnant wage growth, devaluation can cause a fall in real wages. This is because devaluation causes inflation, but if the inflation rate is higher than wage increases, then real wages will fall.

ANS :The differences between fixed and floating type of exchange rate regime will be talked about below. Fixed exchange rate When the currency of a country is exchanged with the currency of another country always at the same rate, then the exchange rate is known as fixed exchange rate. In a fixed exchange rate system the central bank of the country determines the rate at which the currency of the home country will be fixed at with foreign currency. Since the rate is fixed by the central bank of a country, the exchange rate remains stable and does not fluctuate. This is the reason why in a fixed exchange rate, international investments will be encouraged because of this stability and the lack of risk. Since the currency of the country is fixed and does not fluctuate, the chances of a speculative attack is very rare. Since the exchange rate is constant, speculators have no room to gain from fluctuations in the market. In this type of exchange rate, the government has to hold large amounts of reserves, because if the market has ups and downs, then the government needs to intervene to make sure the exchange rate remains constant. Finally, the increase and decrease in the value of currency in terms of foreign currency are termed “revaluation” and “devaluation” respectively.Floating Exchange rateWhen the currency of a country is exchanged foreign currency at different rates, then that type of exchange rate is known as a floating exchange rate. In this type of exchange rate, the value is determined by the market forces of demand and supply. Since the market forces change constantly, altering the value of the exchange rate, there will be fluctuations in the value of the exchange rate. Due to this fluctuation in the exchange rate, international trade and foreign investments will face additional risks called the exchange- rate risk. In this type of exchange rate, speculators try to attack or manipulate the exchange rate so that the fluctuations in the exchange rate create opportunities for them to earn profits. Since a lot government intervention is not needed in this type of exchange rate, governments are not required to maintain large reserves of foreign reserves. Finally, the increase and decrease in the value of currency in terms of foreign currency are termed “appreciation” and “depreciation” respectively.

ANS :Initially when spot rate was $1.25/SFr, $1 would exchange for 0.80SFr. After spot rate went to $1.30/SFr, $1 would exchange for 0.76SFr. Since the purchasing capacity of dollar reduced, we call it depreciation of US dollar. b.The spot rate goes from $1.25/SFr to $1.20/SFr. Answer: Initially when spot rate was $1.25/SFr, $1 would exchange for 0.80SFr. After spot rate went to $1.20/SFr, $1 would exchange for 0.83SFr. Since the purchasing capacity of dollar increased, we call it appreciation of US dollar. c.The spot rate goes from $0.010/yen to $0.009/yen. Answer: Initially when the spot rate was $0.010/yen, $1 would exchange for 100 yen. After spot rate went to $0.009/yen, $1 would exchange for 111.11 yen. Since the purchasing capacity of dollar increased, we call it the appreciation of US dollar. d.The spot rate goes from 100 yen/$ to 111yen/$. Answer: Initially $1 was exchanged for 100 yen, now $1 would be exchanged for 111 yen. Again, US dollar appreciated.

ANS :Let’s suppose we have $1000. If we convert it to yen, it would be 100,000 yen ($0.01/yen). And, if we again convert 100,000 yen to krona, it would be 4000 krone (25 yen/krone). Instead, if we convert it to krone, it would be 5000 krone ($0.20/krone) So, an arbitrage would first convert $1000 to 5000 krone ($0.20/krone). Then, s/he will convert the krone to yen. 5000 krone would be 125,000 yen (25 yen/krone). Again, when 125,000 yen are converted to dollar, it would be $1250 ($0.01/yen). Thus, an arbitrage would earn a profit of $250 dollar by first converting it to the krone, then to the yen, and again finally to the dollar. b.As a result of this arbitrage, what is the pressure on the cross rate between yen and krone? What must the value of cross-rate be to eliminate the opportunity for triangular arbitrage? Answer: The exchange rate will move in a way that will eliminate the arbitrage opportunity. So, the cross-rate between yen and krone can’t remain at 25 yen/krone. To eliminate arbitrage profit, the 5000 krone should be equivalent to the 100,000 yen. Because, if $1000 dollar is exchanged to krone, it would be 5000 ($0.20/krone) and if exchanged to yen, it would be 100,000 yen ($0.01/yen). Thus, the cross-rate between yen and krone should be 20 yen/krone (100,000 yen/5000 krona).Or a.The cross rate between the yen and the krone is too high (the yen value of the krone is too high) relative to the dollar-foreign currency exchange rates. Thus, in a profitable triangular arbitrage, you want to sell kroner at the high cross rate. The arbitrage will be: Use dollars to buy kroner at $0.20/krone, use these kroner to buy yen at 25 yen/krone, and use the yen to buy dollars at $0.01/yen. For each dollar that you sell initially, you can obtain 5 kroner, these 5 kroner can obtain 125 yen, and the 125 yen can obtain $1.25. The arbitrage profit for each dollar is therefore 25 cents. b.Selling kroner to buy yen puts downward pressure on the cross rate (the yen price of krone). The value of the cross rate must fall to 20 (=0.20/0.01) yen/krone to eliminate the opportunity for triangular arbitrage, assuming that the dollar exchange rates are unchanged.

ANS :There are many types of transactions or activities that result in the demand for foreign currency in the spot exchange market. Below I will list 6 activities that affect the demand of the currency. Let us take the American Dollar ($), the USA and the rest of the world as an example for this question. The first is when the export of goods or services of the respective country increase. That means, when the USA exports more goods and services into the world, the demand for the US $ increases as the payments for the goods and services have to be done by the US dollar. The second is the inflow of investment into the USA. When foreign firms and foreign investors invest in the USA in terms of US bonds, equity shares, assets, etc, they have to convert their respective currency into the US $ which leads to the increased demand of the US$ The third is when there is speculative purchasing of the US$ by speculators. When they predict that the currency of US$ is going to appreciate in the near future, they start buying the currency so that they can make a profit out of the US$. This purchasing of the US$ by speculators increases the demand of the US$. The fourth activity when people residing in other countries need to send money into the USA including remittance. When laborers around the world need to send money back to their families and relatives residing in the USA, their respective currency needs to be exchanged into US$ which increases demand of the US$. The fifth activity is the official buying of US$ by the American Central bank. When this happens, the demand for US$ increases. Finally, the 6th activity that increases the demand of US$ is when tourists or students travelling in the US$ require dollar to meet their travelling and education expenses, which is done by exchanging their respective currency into dollars thus creating demand for the US$.