①

03/October

Economy by Prasad Sir

Devaluation of Domestic Currency and its Impact

Due to devaluation of Domestic currency, domestic goods & services becomes more inexpensive for the foreigner so they will demand more domestic goods & services and their demand is our exports, so exports will go up. On the other hand imported goods & services becomes more expensive for domestic consumer and producer and as a result they will demand less importable products which leads to fall in imports.

Revaluation of domestic Currency

$1 \to \$\frac{1}{60}$ | $\$1 = ₹60$

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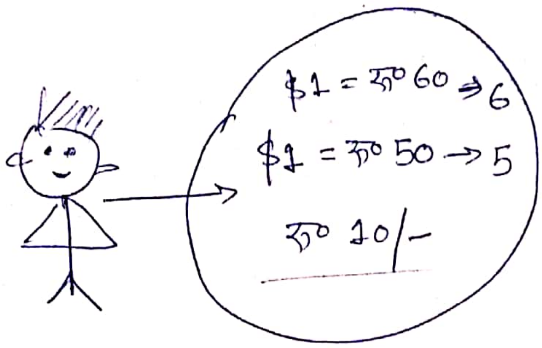
↓ Revaluation of domestic Currency.

If RBI or competent Authority decreases the price of foreign currency from 60 ₹/\$ to 50 Rs/\$, is known as revaluation of domestic Currency.

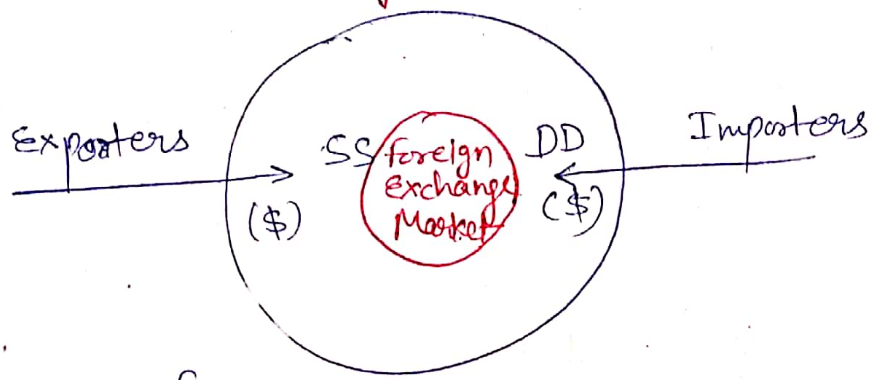
②

Impact of Revaluation of domestic Currency

Exports ↓ Imports ↑



2> Market Exchange Rate System



Market forces

>→ DD for foreign currency
>> SS of foreign currency.

Under this system foreign exchange rate is determined by Market forces i.e, Demand for foreign Currency and Supply of foreign Currency. If demand for foreign currency is more than Supply of foreign currency then the price of foreign currency will go up and it is known as depreciation of domestic currency.

If supply of foreign currency is more than the foreign Demand for foreign currency in the foreign exchange Market then price of foreign currency will decrease. It is known as appreciation of domestic currency.

$1 = रु 70 ↑ ⟶ Depreciation of domestic currency.

$1 = रु 60

$1 = रु 50 ↓ ⟶ Appreciation of domestic currency.

3. Managed Exchange Rate System

There should be no role of competent Authority in this system.

(1) Supply of foreign currency ($) inc(↑)

DD for FC = SS of FC

$1 = रु 60

$100 < $200

RBI → $100 + $100 = $200

SS of F.C > DD for F.C

200 > 100

$1 = रु 30

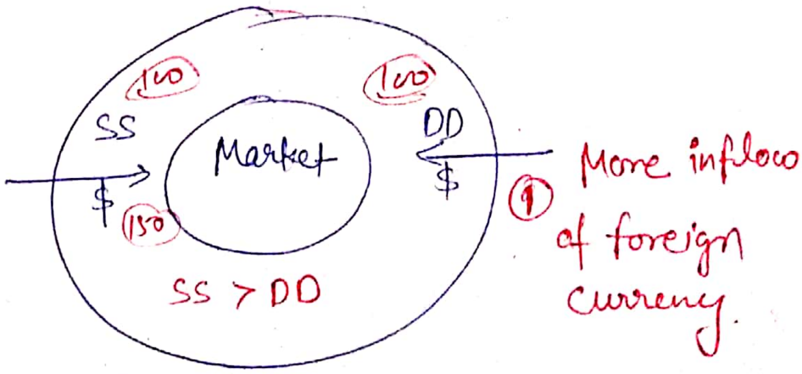
Under this system the ~~forgein~~ foreign exchanged rate is determined by the market forces with the intervention of the competent Authority. Managed exchange Rate system has both the characteristics of fixed Exchange Rate system & Market Exchange Rate System.

② If Demand for foreign Currency ~~is~~ increases much more than a supply of foreign DD FC > SS of FC

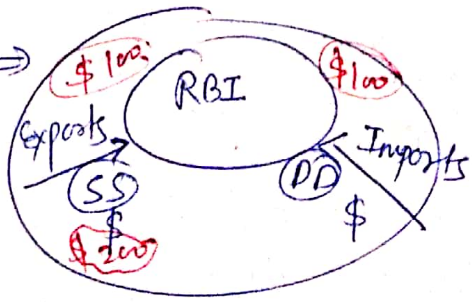
Price of $ ↑s.

$1=₹60 → $1 = ₹ 75

1) Market Exchange Rate System ⇒



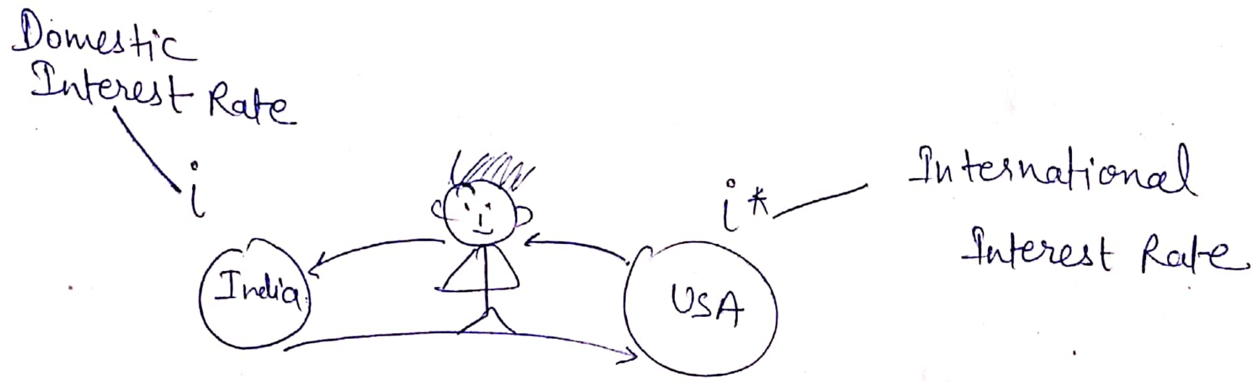
2) fixed exchange Rate system ⇒



Forex - foreign Exchange Reserves

1) Foreign Currencies with the RBI
2) Gold Reserve with RBI
3) SDR with GOI

Fleming - Mundel Model / Interest Rate differential and Capital inflows and Outflows



$$\boxed{\begin{array}{l} i > i^* \Rightarrow \text{Capital inflow} \\ i < i^* \Rightarrow \text{Capital Outflow} \end{array}}$$

5)

BOP (Balance of Payments)

Current Account

i) Trade Balance (BOT)
- Exports of Goods
- Imports of Goods

ii) Invisible Account (Net)
- Services
- Income
- Transfer

Capital Account

- → External Assistance
- → Short-Term Credits
- → External Commercial Borrowings (ECB)
- → NRI deposits with Banks
- → Foreign Capital
  - FDI
  - FPI
- → Any other.

BoP is divided into two major accounts

(i) Current account.

(ii) Capital Account.

Current Account is divided into two sub.account Trade Balance or BOT. & Invisible Account.

Trade Balance only records exports of goods and imports of goods.

→ All the economic transaction. is not related to assest or liabilities is the part of current Account.

→ All economic transactions if it is related to Assets or liabilities then it is a part of Capital Account.

Current Account

① If Inflows of foreign currency is more than the outflows of foreign currencies, this is known as Current Account Surplus. (CAS).

Inflows of foreign Currencies > Outflows of foreign currencies ⇒ CAS.

② If Inflows of foreign Currencies is less than the outflows foreign currencies then this condition is known. as Current Account Deficit (CAD).

Inflows of foreign Currencies < Out flows of foreign currencies ⇒ CAD).

Twins of Deficit

1) fiscal Deficit
2) Current Account Deficit (CAD).

Impact of Higher CAD

Higher CAD
⇓
Outflow of Foreign Currency > Inflow of foreign currency.
Demand for foreign Currency > Supply of foreign currency.
⇓
Depreciation of domestic Currency
⇓
Higher Inflation.

Higher CAD ⇒ BoP deficit
⇓
fall in foreign exchange Reserves.
⇓
External Borrowing
⇓
External debt

* { Nominal Effective Exchange Rate (NEER)
{ Real Effective (ES) exchange Rate (REER)

NEER & REER

The indices of NEER and REER are used as indicators of external competitiveness.
NEER is the weighted average of Bilateral nominal exchange rate.
The REER is defined as a weighted average of nominal exchange rate adjusted for relative price differential between the domestic and foreign countries.

2015 GS III (Mains)
Ques.* "Craze for Gold in Indians has led to a surge in import of gold in recent years and put pressure on BoP and external value of rupee".
In view of this, examine the merits of the Gold Monetisation Scheme.

Purchasing Power Parity (PPP)

USA

India

$ 10 = ₹ 1000

$\boxed{\$ 1 = ₹ 100}$