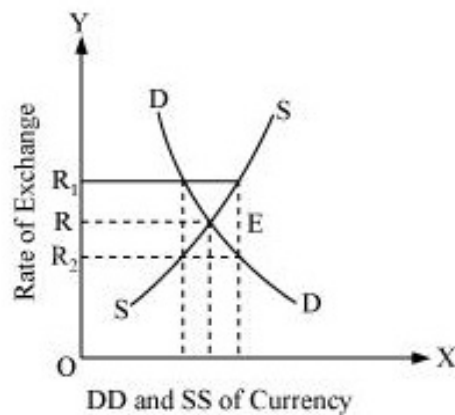




Q6. How is the exchange rate determined under a flexible exchange rate regime?

Ans: Under flexible exchange rate regime, the rate of exchange is determined by the forces of demand and supply. In other words, the equilibrium rate of exchange occurs where demand and supply are equal to each other. This can be illustrated with the help of the given figure:



In the figure, x -axis represents demand for and supply of foreign currency and y -axis represents the exchange rate. DD is the demand curve that is downward slopping, showing an inverse relationship between the rate of exchange and demand for foreign currency. Whereas, the supply curve is upward sloping, showing positive relationship between the rate of exchange and the supply of foreign currency. E is the equilibrium rate of exchange, where the demand equates the supply of foreign exchange (OR). Now, if the exchange rate rises to OR_1 , then the supply exceeds the demand, forcing the exchange rate to fall back to OR. On the contrary, if the exchange rate falls to OR_2 , there is excess demand over supply. Hence, the rate of exchange rises from R_2 to R. Hence, the equilibrium exchange rate (OR) is determined by demand and supply of foreign currency.

Q7. Differentiate between devaluation and depreciation.

Ans:

| Devaluation | Depreciation |
|---|--|
| It occurs when the currency exchange rate is officially lowered under fixed exchange rate system. | When the value of currency falls as compared to other currencies, it is known as depreciation. |
| | |

| | |
|--------------------------------------|--|
| It exists under fixed exchange rate. | It exists under flexible exchange rate. |
| It is due to government's decision | It is due to the demand and supply forces. |

***** END *****