Exercise walk-through

The Foreign Exchange Market ▪ 6.3

eXercise

You must be able to

- model the **foreign exchange market 外汇市场** with supply of and demand for a currency
- determine the **equilibrium exchange rate**
- relate demand for a currency to demand for that country's exports and assets

Method — Supply and demand for a currency

Foreigners **demand** a currency to buy that country's **exports** and **assets**; the currency is **supplied** when residents buy foreign goods and assets.

Method — Equilibrium

The exchange rate settles where the quantity of the currency demanded equals the quantity supplied.

Method — Drivers of demand

More demand for a country's exports or assets $\rightarrow$ more demand for its currency $\rightarrow$ the currency **appreciates**.

Practice 2.1 ▪ 2 marks

State what determines the demand for and supply of a currency.

Solution 2.1

Method: Supply and demand for a currency

Worked steps

demand comes from foreigners buying the country's exports and assets; supply comes from residents buying foreign goods and assets **B1** **B1**.

Practice 2.2 ▪ 1 mark

State what is found at the intersection of currency supply and demand.

Solution 2.2

Method: Supply and demand for a currency

Worked steps

the equilibrium exchange rate **B1**.

Practice 2.3 ▪ 1 mark

State one reason foreigners demand a country's currency.

Solution 2.3

Method: Supply and demand for a currency

Worked steps

to buy that country's exports or assets (any one) **B1**.

Exam-style 3.1 ▪ 1 mark

The equilibrium exchange rate is set by

- **A** the government alone
- **B** supply and demand for the currency
- **C** the CPI
- **D** the money multiplier

Solution 3.1

Method: Equilibrium

A the government alone

B supply and demand for the currency ✓

C the CPI

D the money multiplier

Worked steps

B.

Exam-style 3.2 ▪ 1 mark

Foreigners demand a currency mainly to buy that country's

A debt only

B exports and assets

C imports

D labour abroad

Solution 3.2

Method: Supply and demand for a currency

A debt only

B exports and assets ✓

C imports

D labour abroad

Worked steps

B.

Exam-style 3.3 ▪ 1 mark

Foreign demand for a country's exports rises.

(a) State the effect on the demand for its currency.

(b) State the effect on the exchange rate.

(c) Name this change in the currency's value.

Solution 3.3

Method: Supply and demand for a currency

Worked steps

(a) it rises **B1**. (b) the exchange rate rises **B1**. (c) appreciation **B1**.