

6.4 Effect of Changes in Policies and Economic Conditions on the Foreign Exchange Market

Name: _____ Class: _____ Date: _____

Total: 8 marks

Objective

Build the skills to answer exam questions on **changes in policies and economic conditions in the foreign exchange market**.

You must be able to:

- analyse how a change in **interest rates** shifts the demand for a currency
- explain how differences in **inflation** or **income** affect the exchange rate
- trace how **monetary** and **fiscal policy** influence the currency's value

1 Worked examples

Study these first. Each one shows the method for a question type used later.

■ Interest rates

A higher domestic **real interest rate** attracts foreign investors, **raising demand** for the currency, which **appreciates**.

■ Inflation and income

Higher domestic **inflation** tends to **depreciate** the currency (its goods are dearer); higher domestic **income** raises imports, increasing the **supply** of the currency.

■ Policy

Contractionary monetary policy (higher rates) tends to **appreciate** the currency; expansionary policy tends to **depreciate** it.

2 Practice

2.1 State the effect of higher domestic interest rates on the demand for the currency. [1]

2.2 State how much higher domestic inflation affects the currency's value. [1]

2.3 State how expansionary monetary policy tends to affect the exchange rate. [1]

3 Exam-style questions

3.1 Higher domestic interest rates _____ the demand for the currency. [1]

- **A** raise
 - **B** lower
 - **C** do not change
 - **D** reduce to zero
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3.2 A country with much higher inflation than its trading partners will tend to see its currency [1]

- **A** appreciate
 - **B** depreciate
 - **C** stay fixed
 - **D** disappear
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3.3 A central bank raises interest rates sharply.

(a) State the effect on the demand for the currency. [1]

(b) State the effect on the exchange rate. [1]

(c) Name this change. [1]

4 Go further

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- work through the **6.4 Effect of Changes in Policies and Economic Conditions on the Foreign Exchange Market** lesson on the **Learn** page;
 - read the **Open Economy** section of the AP Macroeconomics handout on the **Know** page.

Solutions

2.1 it raises the demand.

2.2 it tends to depreciate the currency.

2.3 it tends to depreciate the currency (lower rates reduce demand for it).

3.1 A.

3.2 B.

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