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

Name: ____________ Class: __________ Date: ____________ **Total: 8 marks**

KEY WORDS exchange rate 汇率 • appreciates 升值

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]

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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

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

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]