

## 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]

### 3 Exam-style questions

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

|   |   |
|---|---|
| A | B |
| C | D |

- 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 | B |
| C | D |

- 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]