Exercise walk-through

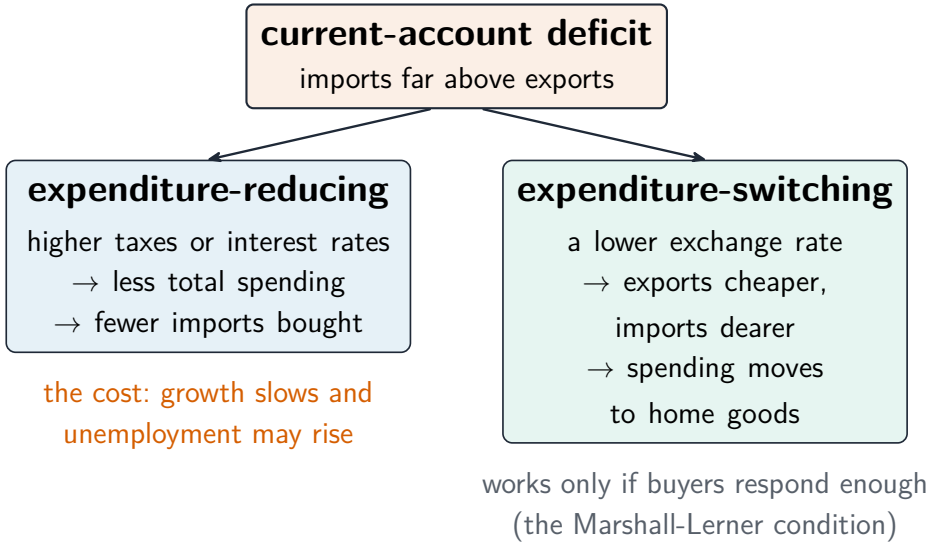
6.4
Exchange rates

International Baccalaureate · IB Diploma · Economics · HL

Exchange rates (3)

- the central bank buys or sells its own currency.
- Under a **fixed exchange rate** , the government or central bank sets the currency's value against another currency and buys or sells to keep it there. The Hong Kong dollar has been fixed to the US dollar since 1983. A deliberate cut in a fixed rate is a **devaluation** ; a deliberate rise is a **revaluation** .
- A **managed exchange rate** floats, but the central bank steps in to limit big moves. The People's Bank of China sets a daily central rate and lets the yuan move only within a band around it.

Figure: The balance of payments



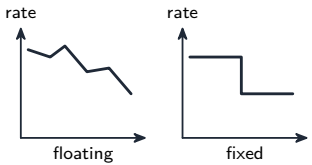
- Two routes out of a deficit: spend less overall, or switch spending to home goods
- Match each part of the diagram to the text.

Key terms (2)

- **Exchange rate**: the price of one currency in terms of another.
- **Current account**: the record of a country's trade in goods and services, **primary income** and **secondary income**.
- **Terms of trade**: the average price of a country's exports relative to the average price of its imports, as an index.
- **Human Development Index**: a composite measure of development based on health, education and income.

Exercises 2.1·2.2

2.1 Distinguish between a depreciation and a devaluation. [2]

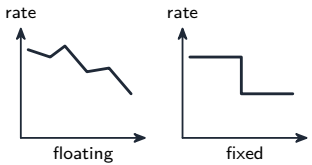


2.2 State **two** reasons why foreigners demand a country's currency. [2]



Exercises 2.1·2.2

2.1 Distinguish between a depreciation and a devaluation. [2]



2.1

depreciation: a fall in the value of a currency in a floating exchange-rate system, caused by market forces; devaluation: a deliberate fall in a fixed exchange rate by the government or central bank

2.2 State **two** reasons why foreigners demand a country's currency. [2]



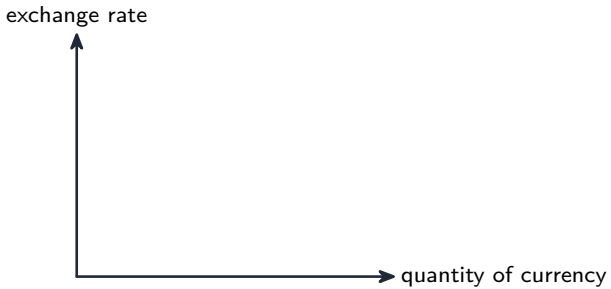
2.2

any two: to buy its exports of goods and services, including tourism; to invest in its firms, property or bonds; to speculate; remittances to families

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Exercise 2.3

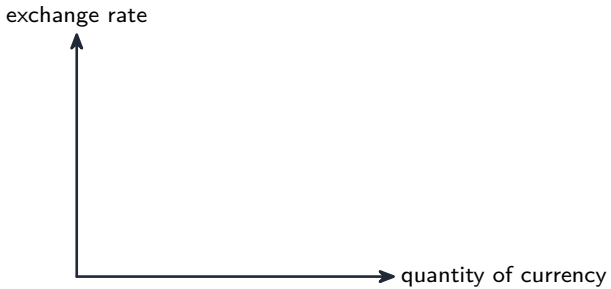
2.3 Using a diagram, explain how a rise in a country's interest rates affects its exchange rate. [4]



[[drawlines:4]]

Exercise 2.3

2.3 Using a diagram, explain how a rise in a country's interest rates affects its exchange rate. [4]



[[drawlines:4]]

2.3

higher interest rates attract financial investment from abroad (hot money); demand for the currency rises: D shifts right; the exchange rate rises: appreciation; correctly labelled diagram: price of the currency (in another currency) vs quantity, $D_1 \rightarrow D_2$, higher rate

Exercises 2.4·2.5

2.4 Explain **one** reason why a depreciation may cause inflation. [3]



2.5 The exchange rate changes from \$1 = ¥150 to \$1 = ¥120. Calculate the percentage change in the value of the dollar, and the dollar price in Japan of a \$30 American shirt before and after, in yen. [3]

\$1 = ¥150

\$1 = ¥120

Exercises 2.4·2.5

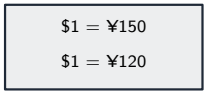
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2.4

imports become more expensive in the domestic currency; imported consumer goods raise the price level directly / imported raw materials and fuel raise firms' costs; so SRAS shifts left / cost-push inflation; higher demand for exports also adds demand-pull inflation

2.5 The exchange rate changes from \$1 = ¥150 to \$1 = ¥120. Calculate the percentage change in the value of the dollar, and the dollar price in Japan of a \$30 American shirt before and after, in yen. [3]



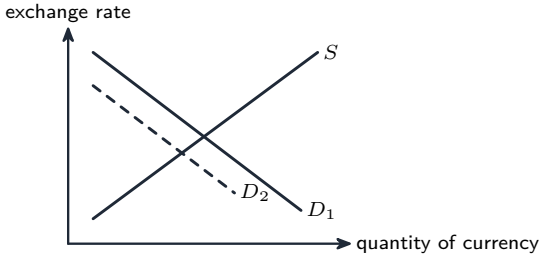
2.5

$(120-150)\div 150\times 100 = -\mathbf{20}\%$: the dollar depreciates against the yen; before: $30\times 150 =$ ¥4500; after: $30 \times 120 =$ ¥3600

Exercise 3.1

3.1 A country's currency has depreciated by 15% in one year.

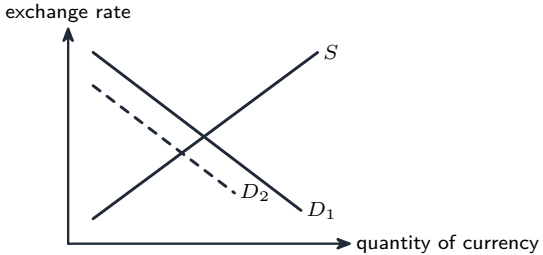
Explain the likely effects of the depreciation on the country's economy. [10]



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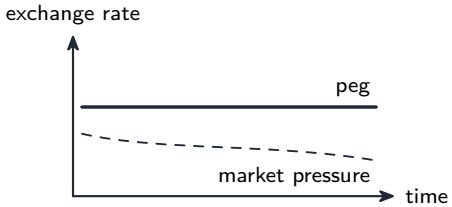
3.1

award up to [10]: exports become cheaper abroad, so export volumes rise; imports become dearer, so import volumes fall; net exports and AD rise: higher real GDP and lower unemployment; the current account balance may improve, depending on PED for exports and imports; imported inflation: dearer imported goods and inputs; lower living standards for those who buy many imports; firms with foreign-currency debts face higher repayments; tourism into the country rises; a clear, structured explanation with an AD/AS or currency diagram

Exercise 3.2

3.2 A small country fixes its currency to the US dollar.

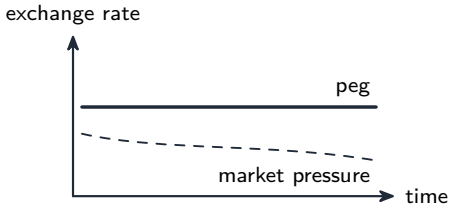
Explain how the central bank maintains the peg if there is pressure for the currency to fall, and evaluate fixed exchange rates. [6]



Exercise 3.2

3.2 A small country fixes its currency to the US dollar.

Explain how the central bank maintains the peg if there is pressure for the currency to fall, and evaluate fixed exchange rates. [6]



3.2

the central bank buys its own currency using foreign reserves, raising demand; it can raise interest rates to attract capital inflows; strength: certainty for trade and investment; discipline against inflation; weakness: needs large reserves; reserves can run out under speculative attack; interest rates must defend the peg rather than support the domestic economy; judgement: suits small, open economies with strong reserves and close ties to the anchor country