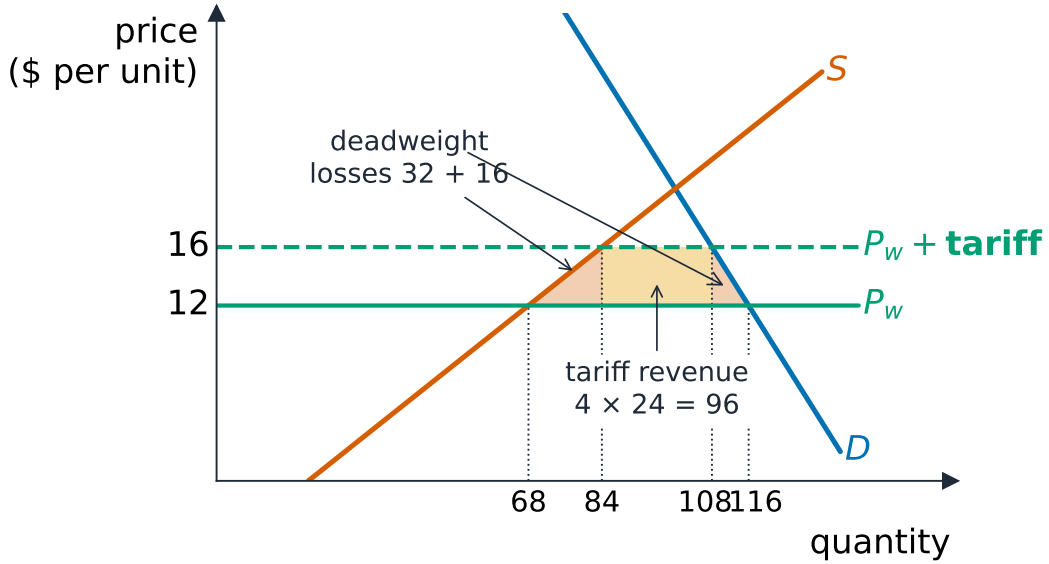
Exercise walk-through

5.4
Exchange rates

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Figure: Trade protection

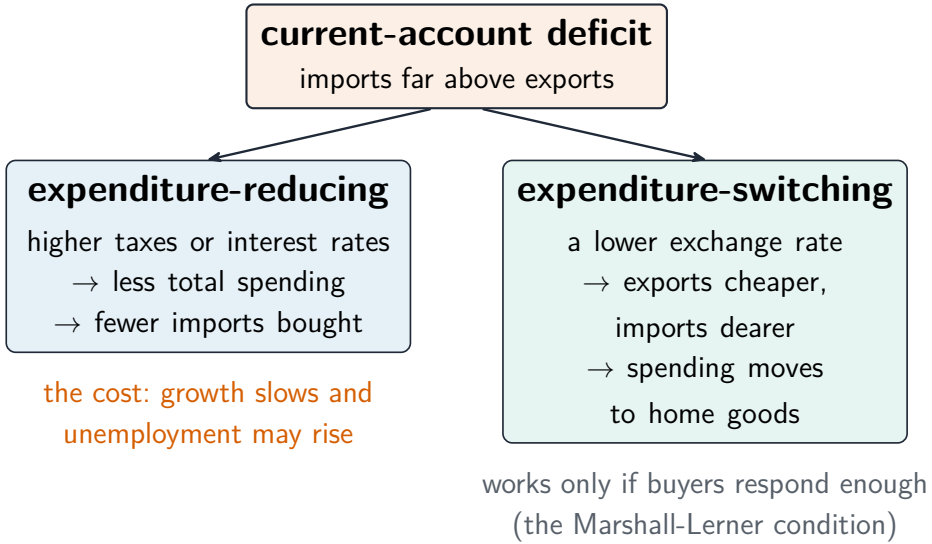


- A **tariff** of 4 halves imports, raises 96 for the government and wastes 48
- Match each part of the diagram to the text.

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.

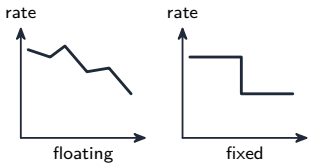
Figure: The balance of payments



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

Exercises 2.1·2.2

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

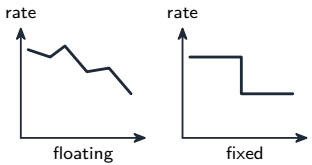


2.2 State **two** reasons why foreigners demand a country's currency. [2]



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]

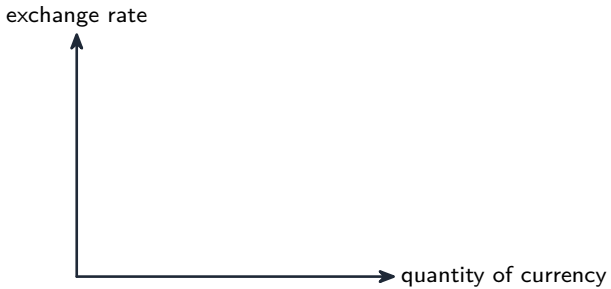


2.2

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

Exercise 2.3

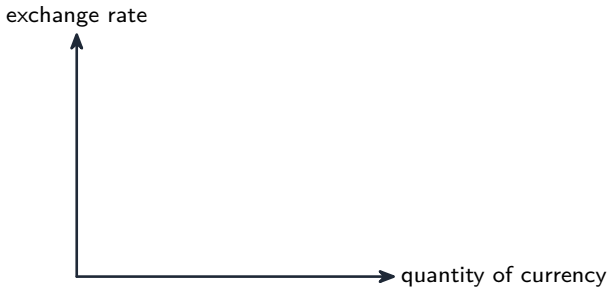
2.3 Using a diagram, explain how a rise in a country's interest rates affects its exchange rate. [4]



[[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

Exercise 2.4

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



Exercise 2.4

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



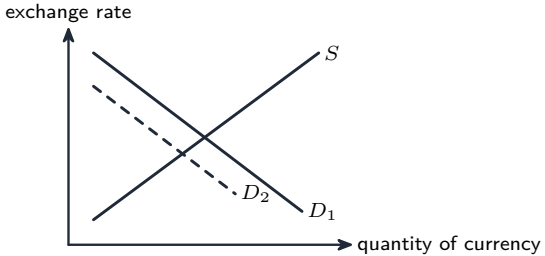
2.4

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

Exercise 3.1

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

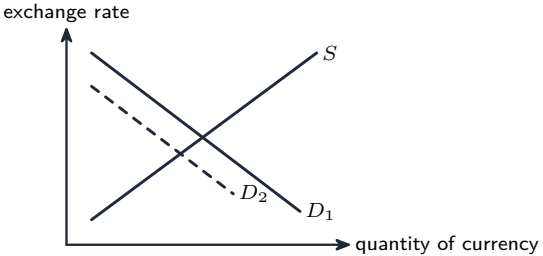
Explain the likely effects of the depreciation on the country's economy. [10]



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]



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