5.4 Exchange rates

Name: _____ Class: _____ Date: _____ **Total: 21 marks**

KEY WORDS exchange rate • depreciation • appreciation • devaluation • fixed exchange rate • foreign exchange reserves

Objective

Build the skills to answer exam questions on **exchange rates** : floating, fixed and managed systems, what makes a currency rise or fall, and the effects of exchange-rate changes on the economy.

You must be able to:

- explain how a floating exchange rate is set by demand and supply
- explain the factors that change the demand for and supply of a currency
- compare floating, fixed and managed exchange rates
- evaluate the effects of a depreciation or appreciation on inflation, growth, unemployment and the current account

1 Key knowledge and worked examples

■ Exchange rates

An **exchange rate** is the price of one currency in terms of another (e.g. €1 = $1.10).

Floating exchange rate: set by **demand and supply** in the foreign exchange market. Foreigners **demand** a currency to buy the country's exports, invest there, or speculate; residents **supply** it to buy imports and invest abroad. **Depreciation**: the currency falls in value; **appreciation**: it rises.

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a currency appreciates when	because
the country's **interest rates** rise relative to others	"hot money" flows in to earn higher returns
foreign **incomes** rise	foreigners buy more exports
the country's **inflation** is lower than abroad	its exports become more competitive
foreign direct investment flows in	investors buy the currency
speculators expect it to rise	they buy now
the central bank buys its own currency	demand rises

Fixed exchange rate: the government or central bank holds the rate at a set level by buying and selling currency with its **reserves** and by changing interest rates. **Devaluation/revaluation** = a deliberate change in a fixed rate. **Managed** (dirty) float: the rate floats but the central bank intervenes to limit swings.

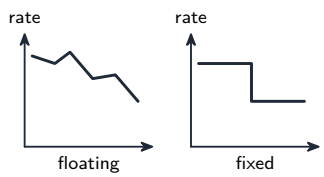
Effects of a depreciation: exports cheaper abroad and imports dearer at home → net exports and AD rise (growth, more jobs) → the **current account** may improve; but **imported inflation** (dearer imported goods and inputs), lower living standards for importers, and dearer foreign debt.

	floating	fixed
strengths	adjusts automatically; interest rates free for domestic goals; no need for big reserves	certainty for traders and investors; discipline against inflation
weaknesses	volatility and uncertainty; speculation	needs reserves; interest rates tied to the peg; risk of speculative attack

Answer shapes: currency market diagram (price of currency vs quantity, D and S) → the shift and new rate → effects on exports, imports, AD, inflation and stakeholders.

2 Practice

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

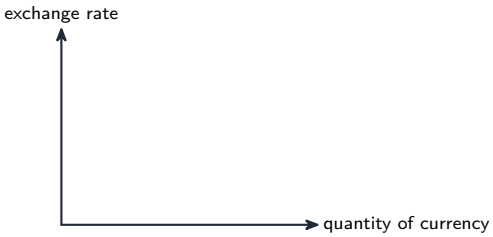


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2.2 State **two** reasons why foreigners demand a country's currency. [2]



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



[[drawlines:4]]

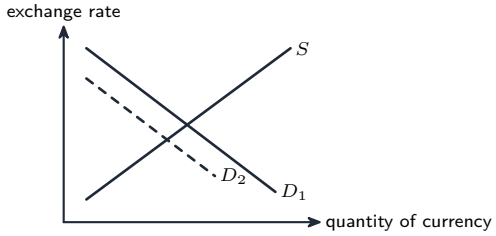
2.4 Explain **one** reason why a depreciation may cause inflation. [3]



3 Exam-style questions

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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Solutions

Marking: **M1** a correct method, **A1** the correct answer, **B1** an independent mark.

Each answer shows the steps, then the **result**.

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

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

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

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

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

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