# 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.

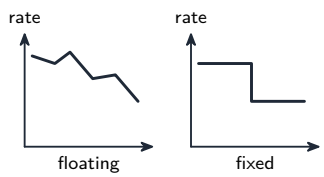
**Effects of a depreciation:** exports cheaper abroad and imports dearer at home → net exports and AD rise (growth, more jobs) → the **current account** may improve; but **imported inflation** (dearer imported goods and inputs), lower living standards for importers, and dearer foreign debt.

| | 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]



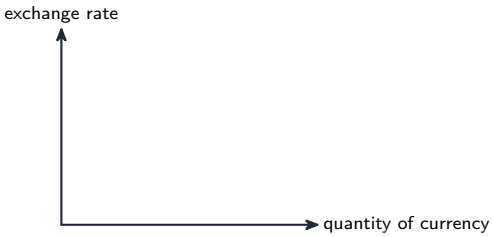


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**2.2** State **two** reasons why foreigners demand a country's currency. [2]




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




[[drawlines:4]]

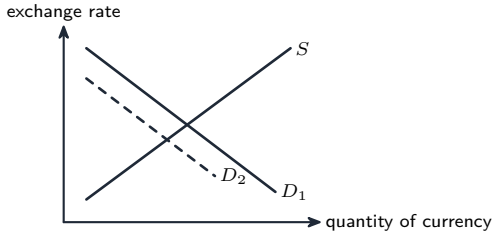
**2.4** Explain **one** reason why a depreciation may cause inflation. [3]




## 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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