Exercise walk-through

Foreign exchange rates ▪ 6.3

eXercise

You must be able to

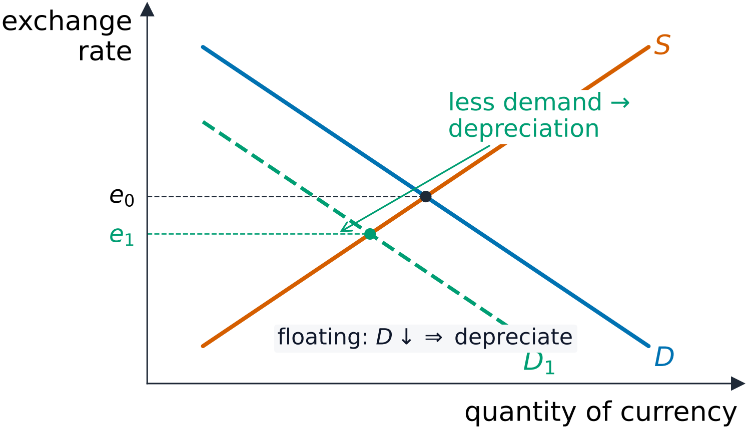
- explain how demand and supply set a floating exchange rate
- distinguish appreciation from depreciation
- analyse the effects of a change in the exchange rate on exports and imports

Method — The exchange rate

- **Floating exchange rate 浮动汇率**: set by demand for and supply of the currency.
- **Appreciation 升值**: the currency rises → exports **dearer**, imports **cheaper** → exports fall, imports rise.
- **Depreciation 贬值**: the currency falls → exports **cheaper**, imports **dearer** → exports rise, imports fall.

Answer shapes: an **Analyse [up to 6]** answer may use a currency diagram; **Discuss [8]** adds a judgement (Ev).

Method — The exchange rate



The exchange rate is set where demand for the currency meets supply

Method — The exchange rate

Appreciation	**Depreciation**
(currency rises in value)	*(currency falls in value)*
exports dearer, imports cheaper → exports fall, imports rise	exports cheaper, imports dearer → exports rise, imports fall

Exam: appreciation hurts export competitiveness; depreciation can boost net exports (SPICED)

How a stronger or weaker currency feeds through to export and import prices

Practice 2.1 ▪ 2 marks

Define the term *exchange rate*.

Solution 2.1

Method: The exchange rate

Worked steps

the price of one currency in terms of another (2 for a clear definition; 1 for a partial idea).

Practice 2.2 ▪ 2 marks

State the effect of a **depreciation** on the price of exports and imports.

Solution 2.2

Method: The exchange rate

Worked steps

exports become cheaper (to foreigners) and imports become dearer (2 for both; 1 for one).

Practice 2.3 ▪ 1 mark

State what sets a floating exchange rate.

Solution 2.3

Method: The exchange rate

Worked steps

the demand for and supply of the currency (1).

Exam-style 3.1 ▪ 1 mark

When a country's currency **appreciates**, its:

A exports become cheaper and imports dearer

B exports become dearer and imports cheaper

C exports and imports both become cheaper

D exports and imports both become dearer

Solution 3.1

A exports become cheaper and imports dearer

B exports become dearer and imports cheaper ✓

C exports and imports both become cheaper

D exports and imports both become dearer

Worked steps

B. An appreciation makes exports dearer and imports cheaper.

Exam-style 3.2 ▪ 4 marks

Using a currency demand and supply diagram, explain how a rise in demand for a country's exports affects its exchange rate.

Solution 3.2

Method: The exchange rate

Worked steps

[4] K 1 + **diagram up to 2** (demand for the currency shifts right, rate rises) + An 1 — foreigners buying more exports must buy the currency → demand for it rises → with supply unchanged, the exchange rate rises (an appreciation).

Exam-style 3.3 ▪ 6 marks

Analyse how a depreciation of a country's currency affects its exports and imports.

Solution 3.3

Method: The exchange rate

Worked steps

[6] K/App/An — a depreciation lowers the currency's value $\rightarrow$ the country's exports become cheaper for foreign buyers, so they buy more $\rightarrow$ exports rise; at the same time imports become dearer for home buyers, so they buy fewer $\rightarrow$ imports fall $\rightarrow$ so a depreciation tends to raise exports and cut imports (which can improve the current account, though it may raise inflation as imports cost more).