Edexcel (B) Economics A-level

Theme 2: The Wider Economic Environment

2.4 Life in a Global Economy

2.4.4 Exchange rates

Notes

Changes in exchange rates

The exchange rate is the weight of one currency relative to another.

Depreciation: When the value of a currency falls relative to another currency in a floating exchange rate system.

Appreciation: When the value of a currency increases. Each pound will buy more dollars, for example.

Devaluation: This is when the value of a currency is officially lowered in a fixed exchange rate system.

Revaluation: This is when the currency's value is adjusted relative to a baseline, such as the price of gold, another currency or wage rates.

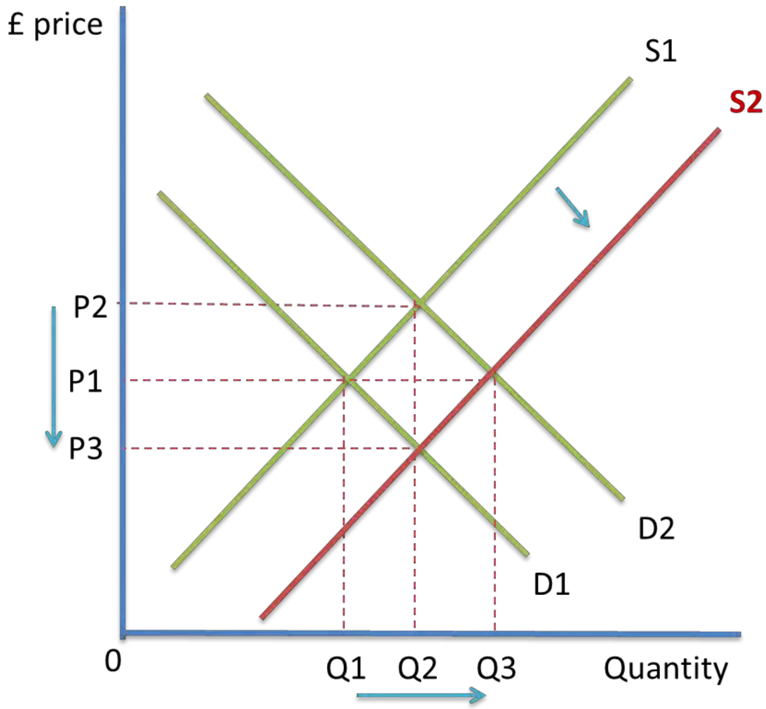
Floating:

The value of the exchange rate in a floating system is determined by the forces of supply and demand.

In a floating exchange rate system, the market equilibrium price is at P1. When demand increases from D1 to D2, the exchange rate appreciates to P2.

Fixed:

A fixed exchange rate has a value determined by the government compared to other currencies.



In a fixed exchange rate system, the supply of the currency can be manipulated by the central bank, which can buy or sell the currency to change the price to where they want. In the diagram, the supply has been increased (S1 to S2) by selling the currency so more is on the market (Q1 to Q3). The currency depreciates as a result (P2 → P3), which makes exports more competitive.

Impact of changing exchange rates on firms

A depreciation in the pound means that UK exports become more price competitive. Firms could then reduce the price of the good in the export market to increase sales, or they can keep the price the same to increase their profit margins.

However, if UK goods are relatively price inelastic, a depreciation in the pound will not increase sales in the export market significantly. Moreover, it depends on the rate of economic growth in the export market. The higher the level of consumer and firm confidence, and the more disposable income they have, the more likely they are to purchase UK exports.

If firms are net importers of raw materials, costs of production will increase because imports are relatively more expensive when the pound is weaker. This could make the firm less internationally competitive, and it could mean they make lower profits. However, if firms have fixed contracts for how long they import materials from another country, then changes in the exchange rate will not affect quantity purchased or the price paid. This reduces uncertainty of production costs for firms.

If the pound depreciates, firms might think that they can increase their profit margins by keeping the price the same, without having to increase efficiency or productivity to lower their average costs.

Interpretation of exchange rate data and effective exchange rates

The effective exchange rate (EER) index describes the strength of one currency to a basket of other currencies using an index. The weighting of each currency is dependent on how important trade between the country and its partners is. A change in the pattern of trade causes a change in the relative weight of each currency.