CIE Economics AS-level

Topic 4: The Macroeconomy

d) Exchange rates

Notes

Definitions and measurement of exchange rates

Nominal exchange rate: This is the weight of one currency relative to another, without being adjusted for inflation.

Real exchange rate: This is when the exchange rate is adjusted for inflation to give a more accurate reflection of purchasing power.

Trade-weighted exchange rate: This is the weighted average of the exchange rate, of the domestic currency relative to foreign currencies, where the weight of each currency is equal to the share in trade. The more the domestic country trades with a foreign country, the greater the weight of the currency.

The determination of exchange rates

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

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

Managed float: This occurs when the exchange rate floats on the market, but the central bank of the country buys and sells currencies to try and influence their exchange rate.

Depreciation and appreciation

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 and revaluation

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.

The factors underlying changes in exchange rates

Inflation:

A lower inflation rate means exports are relatively more competitive. This increases demand for the currency. This causes the currency to appreciate.

Interest rates:

An increase in interest rates, relative to other countries, makes it more attractive to invest funds in the country because the rate of return on investment is higher. This increases demand for the currency, causing an appreciation. This is known as **hot money.**

Speculation:

If speculators think a currency will appreciate in the future, demand will increase in the present, since they believe a profit can be made by selling the currency in the future. This can cause an increase in the value of the currency.

Other currencies:

If markets are concerned about major economies, such as the EU, the currency might rise. This happened with the Swiss Franc in 2010 when markets were worried about the EU economy.

Government finances:

A government with a high level of debt is at risk of defaulting, which could cause the currency to depreciate. This is since investors start to lose confidence in the economy, so they sell their holdings of bonds.

Balance of payments:

When the value of imports exceeds exports, there is a current account deficit. Countries which struggle to finance this, such as through attracting capital inflows, have currencies which depreciate as a result.

International competitiveness:

An increase in competitiveness increases demand for exports, which increases demand for the currency. This causes an appreciation of the currency.

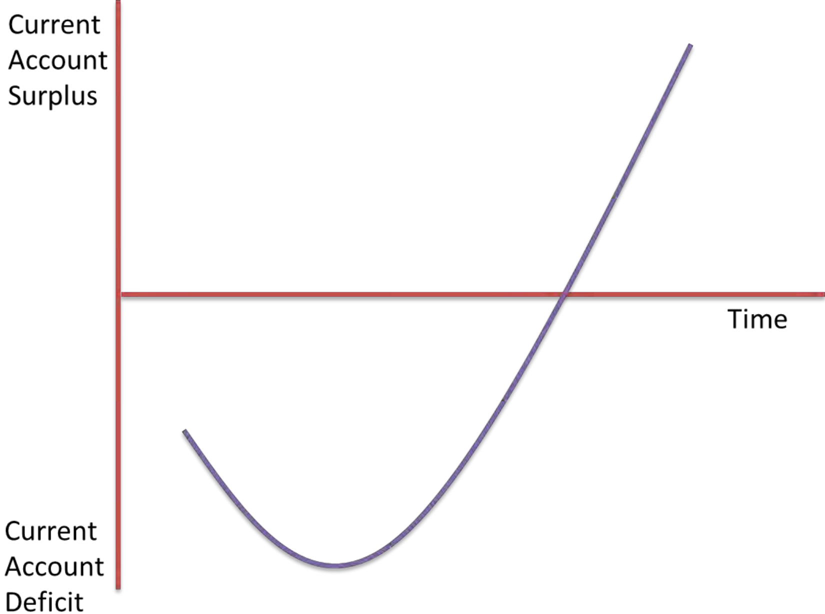
Government intervention:

Governments might try and influence their currency, such as by maintaining a fixed exchange rate. For example, China has previously kept the Yuan undervalued by buying US dollar assets to make their exports seem relatively cheaper.

The effects of changing exchange rates on the domestic and external economy

Marshall-Lerner condition and the J-curve effect

The Marshall-Lerner condition states that a devaluation in a currency only improves the balance of trade if the absolute sum of long run export and import demand elasticities is greater than or equal to 1.



The J-curve effect occurs when a currency is devalued. Since devaluing the currency causes imports to become more expensive, at first the total value of imports increases, which worsens the deficit. Eventually, the value of exports decreases, which leads to a reduction in the trade deficit.

When the currency is devalued, there may be a time lag in changing the volume of exports and imports. This could be due to trade contracts and the price inelasticity of demand for imports in the short run, whilst consumers search for alternatives. In the long run, consumers might start purchasing domestic products, for example, which helps improve the deficit.

The effect of exchange rates on AD

Exchange rate affects AD because they affect the price of exports and imports. If the exchange rate appreciates, AD is likely to fall since imports become cheaper and exports become more expensive.