AQA Economics A-level

Macroeconomics

Topic 6: The International Economy

6.4 Exchange rate systems

Notes

How exchange rates are determined in freely floating exchange rate systems

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

Floating:

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

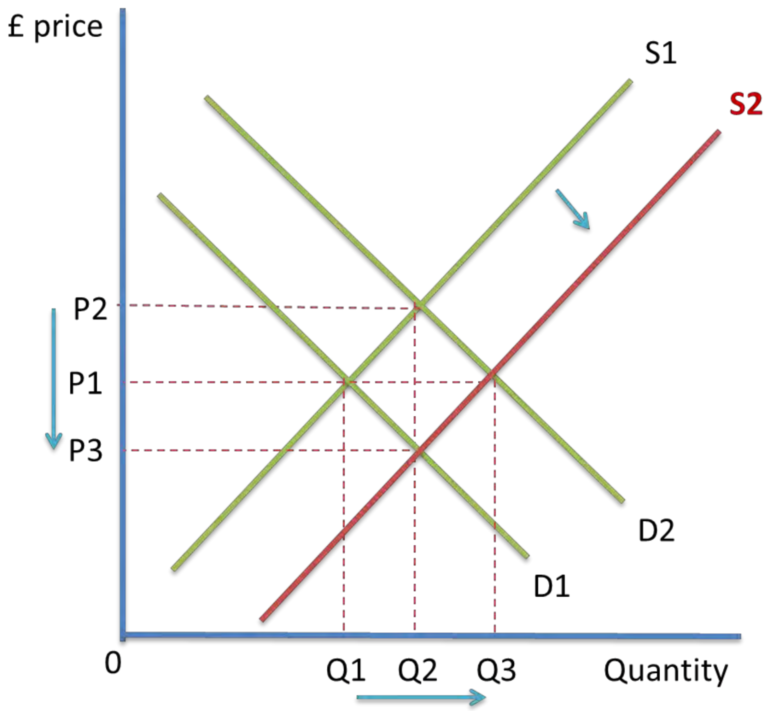
In a floating exchange rate system, the market equilibrium price is at P1. When demand increases from D1 to D2, the exchange rate appreciates to P2.

The demand for a currency is equal to exports plus capital inflows. The supply of a currency is equal to imports plus capital outflows.

How governments can intervene to influence the exchange rate

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.

Managed:

Managed exchange rate systems combine the characteristics of fixed and floating exchange rate systems. The currency fluctuates, but it doesn't float on a fully free market. This is 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.

The Japanese central bank has also attempted to make exports more competitive by manipulating the Yen, even though the Yen floats on the market.

The Indian rupee fluctuates on the market, but the central bank intervenes when it falls outside a set range.

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.

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.**

Quantitative easing:

This is used by banks to help to stimulate the economy when standard monetary policy is no longer effective. This has inflationary effects since it increases the money supply, and it can reduce the value of the currency. QE is usually used where inflation is low and it is not possible to lower interest rates further.

Foreign currency transactions:

The Bank of England uses this to manage the UK's gold and foreign currency reserves, as well as managing the MPC's pool of foreign currency reserves. It involves buying and selling foreign currency to manipulate the domestic currency. China kept large reserves of the US Dollar by purchasing government bonds, in order to undervalue the Yuan.

The advantages and disadvantages of fixed and floating exchange rate systems

	Advantages	**Disadvantages**
Fixed	Allows for firms to plan investment, because they know	The government and the central bank do not necessarily

	that they will not be affected by harsh fluctuations in the exchange rate. It gives the monetary policy a focused target to work towards.	know better than the market where the currency should be. The balance of payments does not automatically adjust to economic shocks. It can be costly and difficult for the government to hold large reserves of foreign currencies.
Floating	The exchange rate automatically adjusts to economic shocks. It gives the monetary policy more freedom to focus on other macroeconomic objectives.	The fluctuations in the price of the exchange rate can be unpredictable, which can make investment planning difficult. It can also affect the exports and imports of a country, which could cause a lot of unemployment if an industry is affected in particular. It could make the exchange rate vulnerable to speculative shocks.

Advantages and disadvantages for a country of joining a currency union e.g the Eurozone

Members of a monetary union share the same currency. This is more economically integrated than a customs union and free trade area. The Eurozone is an example of this.

A common central monetary policy is established when a monetary union is formed. The single European currency, the Euro, was implemented in 1999 to form the Eurozone.

Monetary unions use the same interest rate. The Euro, for example, floats against the US Dollar and the Pound Sterling. Member nations are required to control their government finances, so budget deficits cannot exceed 3% of GDP. This is one of the four convergence criteria countries have to meet in order to join the Euro. The other three are:

- Gross National Debt has to be below 6% of GDP
- Inflation has to be below 1.5% of the three lowest inflation countries

- The average government bond yield has to be below 2% of the yield of the countries with the lowest interest rates. This ensures there can be exchange rate stability.

The optimal currency zone is created when countries achieve real convergence. Member countries have to respond similarly to external shocks or policy changes. There has to be flexibility in product markets and labour markets to deal with shocks. This could be through the geographical and occupational mobility of labour, and wage and price flexibility in labour markets. Fiscal transfers could be used to even out some regional economic imbalances.

Advantages

The participating countries have more currency stability, and the currency is less prone to speculative shocks. This gives future markets more certainty, so there is more investment and growth potential.

There are fewer admin fees and less red tape when travelling abroad or exchanging money.

This also benefits firms which trade with the different member states. It is especially beneficial to small firms, who benefit from the time and money saving of a common currency.

The German monetary credibility might result in all member states having a lower interest rate. This might encourage more investment and spending, which might create more jobs.

Disadvantages

Labour mobility is limited across Europe due to language barriers. Moreover, the differences in economic performance between member countries means a common monetary policy might not be effective.

The exchange rate is not flexible to meet each country's need, such as if they need a boost in exports.

Member nations lose sovereignty when there is a common monetary union. This means that countries with a strong economy have to cooperate with countries that have weaker economies. They cannot adapt their policies to meet each individual requirement.

The one-off cost of joining a currency union of changing labels and prices can be significant.