

3.2 EXCHANGE RATES

Terms & Objectives

TERMS

1. exchange rate
2. freely floating exchange rate system
3. appreciation
4. depreciation
5. currency speculation
6. fixed exchange rate system
7. devaluation
8. revaluation
9. managed exchange rates
10. overvalued currency
11. undervalued currency

OBJECTIVES

I. FREELY FLOATING EXCHANGE RATES

a. Determination of freely floating exchange rates

- ∅ 1. Explain that the value of an exchange rate in a floating system is determined by the demand for, and supply of, a currency.
- ∅ 2. Draw a diagram to show determination of exchange rates in a floating exchange rate system.
- ∅ 3. Calculate the value of one currency in terms of another currency. (HL)
- ∅ 4. Calculate the exchange rate for linear demand and supply functions. (HL)
- ∅ 5. Plot demand and supply curves for a currency from linear functions and identify the equilibrium exchange rate. (HL)
- ∅ 6. Using exchange rates, calculate the price of a good in different currencies. (HL)

b. Causes of changes in the exchange rate

- ∅ 7. Explain the factors that lead to changes in currency demand and supply, including foreign demand for a country's exports, domestic demand for imports, relative interest rates, relative inflation rates, investment from overseas in a country's firms (foreign direct investment and portfolio investment) and speculation.
- ∅ 8. Distinguish between a depreciation of the currency and an appreciation of the currency.
- ∅ 9. Draw diagrams to show changes in the demand for, and supply of, a currency.
- ∅ 10. Calculate the changes in the value of a currency from a set of data. (HL)

c. *The effects of exchange rate changes*

- ∅ **11.** Evaluate the possible economic consequences of a change in the value of a currency, including the effects on a country's inflation rate, employment, economic growth and current account balance.

II. GOVERNMENT INTERVENTION

a. *Fixed exchange rates*

- ∅ **12.** Describe a fixed exchange rate system involving commitment to a single fixed rate.
- ∅ **13.** Distinguish between a devaluation of a currency and a revaluation of a currency.
- ∅ **14.** Explain, using a diagram, how a fixed exchange rate is maintained.

b. *Managed exchange rates (managed float)*

- ∅ **15.** Explain how a managed exchange rate operates, with reference to the fact that there is a periodic government intervention to influence the value of an exchange rate.
- ∅ **16.** Examine the possible consequences of overvalued and undervalued currencies.

c. *Evaluation of different exchange rate systems*

- ∅ **17.** Compare and contrast a fixed exchange rate system with a floating exchange rate system, with reference to factors including the degree of certainty for stakeholders, ease of adjustment, the role of international reserves in the form of foreign currencies and flexibility offered to policy makers.