Exercise walk-through

Exchange rates ▪ 11.2

eXercise

You must be able to

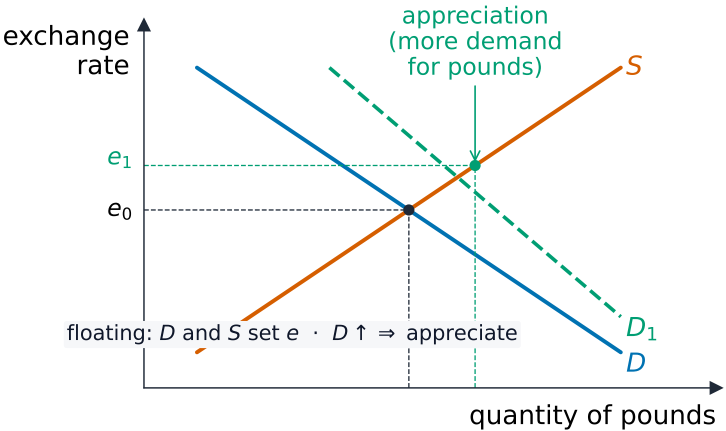
- distinguish nominal, real and trade-weighted (effective) exchange rates
- describe floating, fixed and managed systems
- analyse the effects of a change in the exchange rate

Method — Measuring and changing the rate

- **Nominal 名义**: the everyday market rate. **Real 实际**: adjusted for price differences (true competitiveness). **Effective/trade-weighted 有效**: an average against all trading partners.
- **Systems:** floating, fixed, managed.
- Floating: **appreciation 升值** / **depreciation 贬值**. Fixed: **revaluation 法定升值** / **devaluation 法定贬值**.

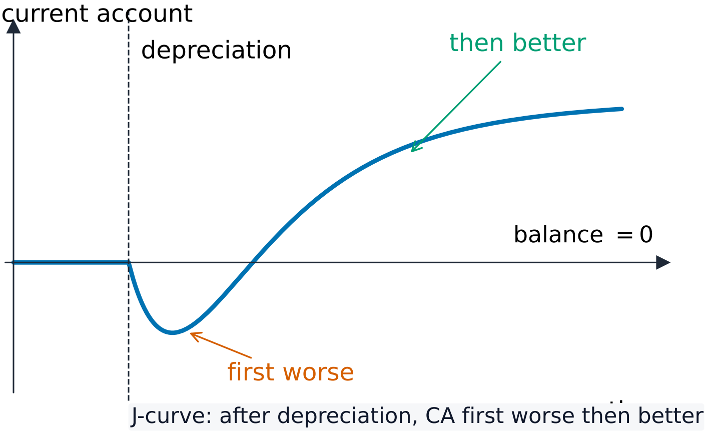
Answer shapes: an **Explain [up to 8]** answer may use a currency diagram (AO3); **Discuss [12]** adds a judgement (AO4).

Method — Measuring and changing the rate



A floating exchange rate is set where demand for the currency meets supply

Method — Measuring and changing the rate



After a depreciation the current account first worsens, then improves — a J shape

Practice 2.1 ▪ 2 marks

State the difference between the *nominal* and the *real* exchange rate.

Solution 2.1

Method: Measuring and changing the rate

Worked steps

the nominal rate is the everyday market rate between two currencies; the real rate adjusts it for differences in prices, showing true competitiveness (2 for a clear difference; 1 for a partial idea).

Practice 2.2 ▪ 2 marks

Define the term *effective (trade-weighted) exchange rate*.

Solution 2.2

Method: Measuring and changing the rate

Worked steps

an average of a currency's value against all its trading partners, weighted by how much trade is done with each (2 for a clear definition; 1 for a partial idea).

Practice 2.3 ▪ 2 marks

State the difference between a *depreciation* and a *devaluation*.

Solution 2.3

Method: Measuring and changing the rate

Worked steps

a depreciation is a fall in value under a floating system (set by the market); a devaluation is a deliberate fall under a fixed system (set by the central bank) (2 for a clear difference; 1 for a partial idea).

Exam-style 3.1 ▪ 1 mark

Under a **fixed** exchange-rate system, a deliberate fall in the currency's value is a:

A depreciation

B appreciation

C devaluation

D revaluation

Solution 3.1

Method: Measuring and changing the rate

A depreciation

B appreciation

C devaluation ✓

D revaluation

Worked steps

C. A deliberate fall under a fixed system is a devaluation.

Exam-style 3.2 ▪ 8 marks

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

Solution 3.2

Method: Measuring and changing the rate

Worked steps

[8] AO1 1 + **AO3 diagram up to 4** (demand for the currency shifts left, rate falls) + AO2/AO3 up to 3 — fewer exports sold means foreigners need less of the currency → demand for it shifts left → with supply unchanged the exchange rate falls (a depreciation).

Exam-style 3.3 ▪ 12 marks

Discuss whether a fixed exchange rate is better than a floating exchange rate.

Solution 3.3

Method: Measuring and changing the rate

Worked steps

[12] AO1/AO2/AO3 up to 8 + AO4 up to 4. **Fixed:** gives certainty for traders and investors and disciplines inflation — but needs large reserves and removes monetary independence. **Floating:** adjusts automatically and frees monetary policy — but can be volatile and speculative. Judgement: neither is always better — a fixed rate suits a country seeking stability and credibility, a floating rate one wanting policy freedom; it depends on the economy's needs.