Exercise walk-through

Exchange rates ▪ 6.4

eXercise

You must be able to

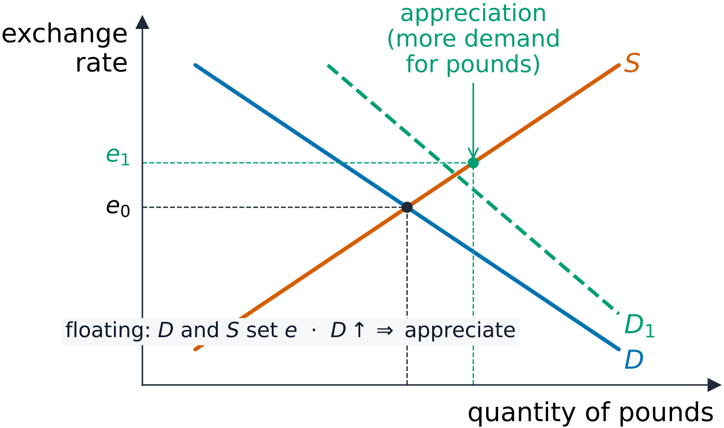
- define the three exchange-rate systems
- explain how demand and supply set a floating rate
- analyse the effects of a depreciation on trade and inflation

Method — A floating exchange rate

- **Floating 浮动汇率**: set by demand and supply. **Fixed 固定汇率**: held by the central bank. **Managed 管理浮动**: mostly floats, occasional intervention.
- **Appreciation 升值**: the currency rises $\rightarrow$ exports dearer, imports cheaper.
- **Depreciation 贬值**: the currency falls $\rightarrow$ exports cheaper, imports dearer $\rightarrow$ can help the current account but raise inflation.

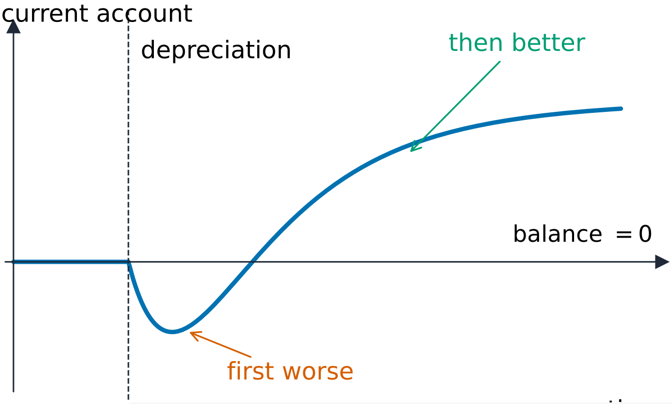
Answer shapes: an **Explain [up to 8]** answer may use a currency demand–supply diagram (AO3); **Discuss [12]** adds a judgement (AO4).

Method — A floating exchange rate



More demand for the currency raises its value — an appreciation

Method — A floating exchange rate



J-curve: after depreciation, CA first worse then better

After a depreciation the trade balance first worsens, then improves — the J-curve

Practice 2.1 ▪ 2 marks

Define the term *exchange rate*.

Solution 2.1

Method: A floating exchange rate

Worked steps

the price of one currency in terms of another (2 for a clear definition; 1 for a partial idea).

Practice 2.2 ▪ 2 marks

State the effect of a **depreciation** on the price of exports and imports.

Solution 2.2

Method: A floating exchange rate

Worked steps

exports become cheaper (to foreigners) and imports become dearer (2 for both; 1 for one).

Practice 2.3 ▪ 2 marks

State the difference between a *floating* and a *fixed* exchange rate.

Solution 2.3

Method: A floating exchange rate

Worked steps

a floating rate is set freely by demand and supply; a fixed rate is held at a set value by the central bank (2 for a clear difference; 1 for a partial idea).

Exam-style 3.1 ▪ 1 mark

A depreciation of a country's currency will make its:

A exports dearer and imports cheaper

B exports cheaper and imports dearer

C exports and imports both cheaper

D exports and imports both dearer

Solution 3.1

Method: A floating exchange rate

A exports dearer and imports cheaper

B exports cheaper and imports dearer ✓

C exports and imports both cheaper

D exports and imports both dearer

Worked steps

B. A depreciation makes exports cheaper and imports dearer.

Exam-style 3.2 ▪ 8 marks

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

Solution 3.2

Method: A floating exchange rate

Worked steps

[8] AO1 1 + **AO3 diagram up to 4** (demand for the currency shifts right, rate rises) + AO2/AO3 up to 3 — foreigners buying more exports must buy the currency → demand for it rises → with supply unchanged, the exchange rate rises (an appreciation).

Exam-style 3.3 ▪ 12 marks

Discuss whether a depreciation of the currency is good for an economy.

Solution 3.3

Method: A floating exchange rate

Worked steps

[12] AO1/AO2/AO3 up to 8 + AO4 up to 4. **Good:** cheaper exports and dearer imports can raise net exports, improving the current account and supporting jobs. **Bad:** dearer imports raise costs and can cause cost-push inflation; the benefit depends on the **Marshall–Lerner condition** (elastic demand) and may be slow (the J-curve). Judgement: a depreciation helps if export and import demand are elastic, but it risks inflation — its effect depends on elasticities and the cause of the fall.