Exercise walk-through

Effect of Changes in Policies and Economic Conditions on the Foreign Exchange Market ▪ 6.4

eXercise

You must be able to

- analyse how a change in **interest rates** shifts the demand for a currency
- explain how differences in **inflation** or **income** affect the exchange rate
- trace how **monetary** and **fiscal policy** influence the currency's value

Method — Interest rates

A higher domestic **real interest rate** attracts foreign investors, **raising demand** for the currency, which **appreciates**.

Method — Inflation and income

Higher domestic **inflation** tends to **depreciate** the currency (its goods are dearer); higher domestic **income** raises imports, increasing the **supply** of the currency.

Method — Policy

Contractionary monetary policy (higher rates) tends to **appreciate** the currency; expansionary policy tends to **depreciate** it.

Practice 2.1 ▪ 1 mark

State the effect of higher domestic interest rates on the demand for the currency.

Solution 2.1

Method: Interest rates

Worked steps

it raises the demand **B1**.

Practice 2.2 ▪ 1 mark

State how much higher domestic inflation affects the currency's value.

Solution 2.2

Method: Inflation and income

Worked steps

it tends to depreciate the currency **B1**.

Practice 2.3 ▪ 1 mark

State how expansionary monetary policy tends to affect the exchange rate.

Solution 2.3

Method: Policy

Worked steps

it tends to depreciate the currency (lower rates reduce demand for it) **B1**.

Exam-style 3.1 ▪ 1 mark

Higher domestic interest rates ________ the demand for the currency.

- **A** raise
- **B** lower
- **C** do not change
- **D** reduce to zero

Solution 3.1

Method: Interest rates

A raise ✓

B lower

C do not change

D reduce to zero

Worked steps

A.

Exam-style 3.2 ▪ 1 mark

A country with much higher inflation than its trading partners will tend to see its currency

A appreciate

B depreciate

C stay fixed

D disappear

Solution 3.2

Method: Inflation and income

A appreciate

B depreciate ✓

C stay fixed

D disappear

Worked steps

B.

Exam-style 3.3 ▪ 1 mark

A central bank raises interest rates sharply.
(a) State the effect on the demand for the currency.
(b) State the effect on the exchange rate.
(c) Name this change.

Solution 3.3

Method: Interest rates

Worked steps

(a) it rises **B1**. (b) the exchange rate rises **B1**. (c) appreciation **B1**.