

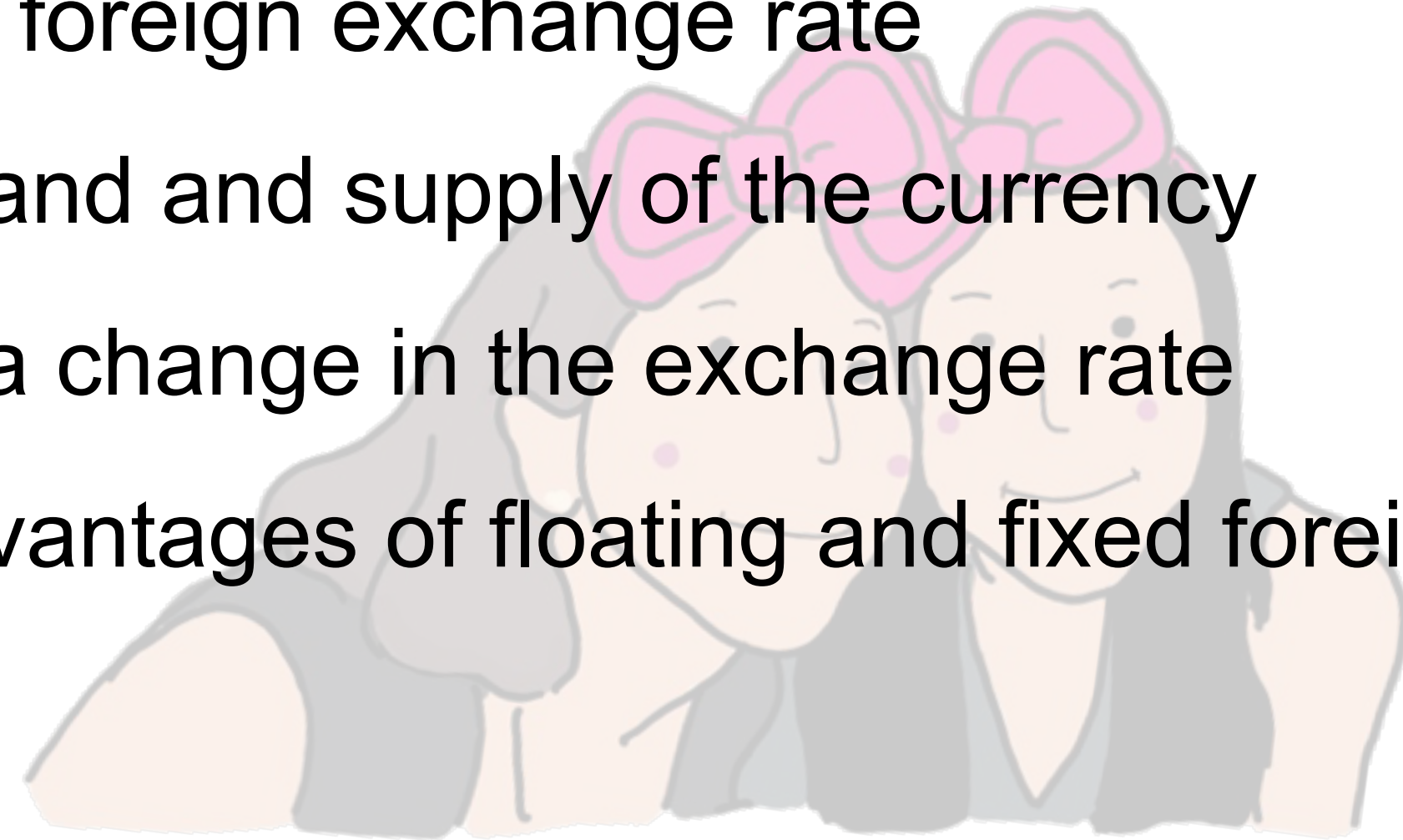


MACROECONOMICS - Foreign exchange rates

By Kru P'Da and Kru P'Eve Knockout.Economics

Overviews

1. Foreign exchange rate systems
2. The determination of a foreign exchange rate
3. Factors influence demand and supply of the currency
4. The consequences of a change in the exchange rate
5. Advantages and disadvantages of floating and fixed foreign exchange rate



1. Foreign exchange systems

Exchange rate : price of one currency in terms of another currency eg. 1 £ = 50 ₪

Foreign exchange rate systems

1. A fixed exchange rate

: the value of a currency is fixed against another currency by the central bank.

- **Revalued Currency** => A rise in fixed currency
- **Devalued Currency** => A fall in fixed currency

2. A floating exchange rate

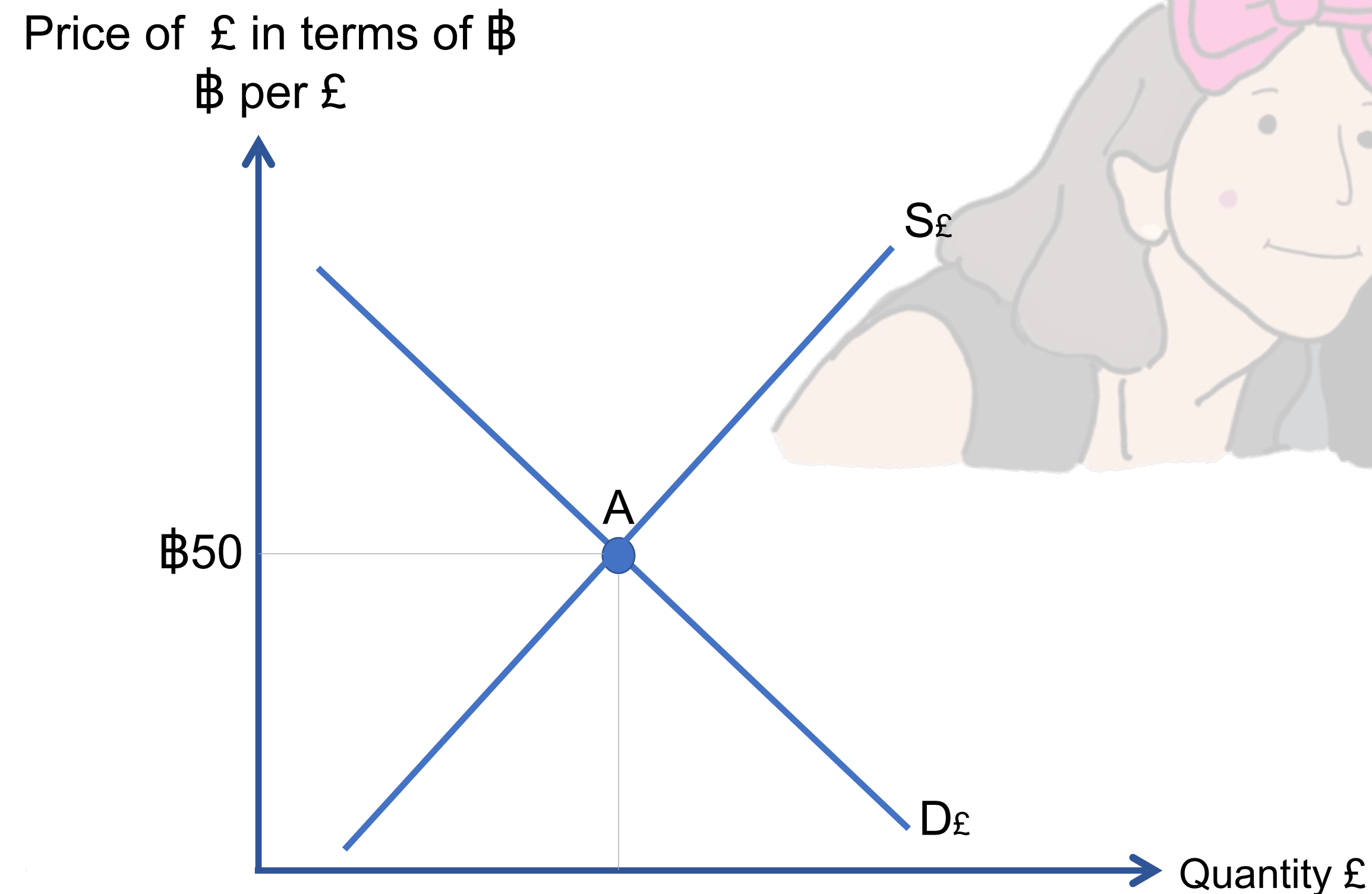
: the value of a currency is determined by demand and supply of a currency.

- **Appreciated Currency** => A rise in floating currency
- **Depreciated Currency** => A fall in floating currency

2. The determination of a foreign exchange rate

1. Floating exchange rate system

An exchange rate is determined by demand and supply of a currency.



Demand for £ : influenced by UK exports and money inflow into the UK

Supply of £ : influenced by UK imports and money outflow from the UK

2. The determination of a foreign exchange rate

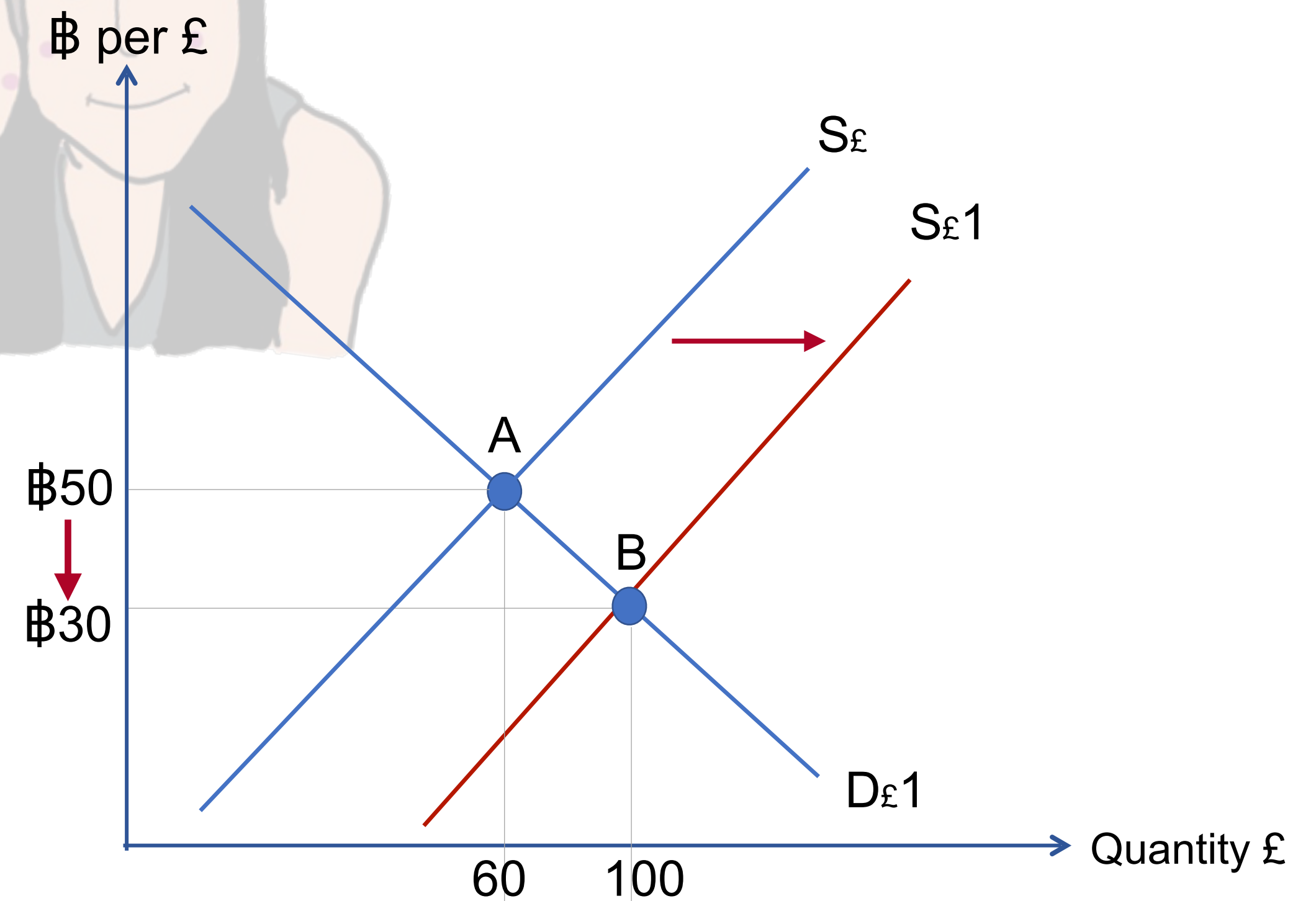
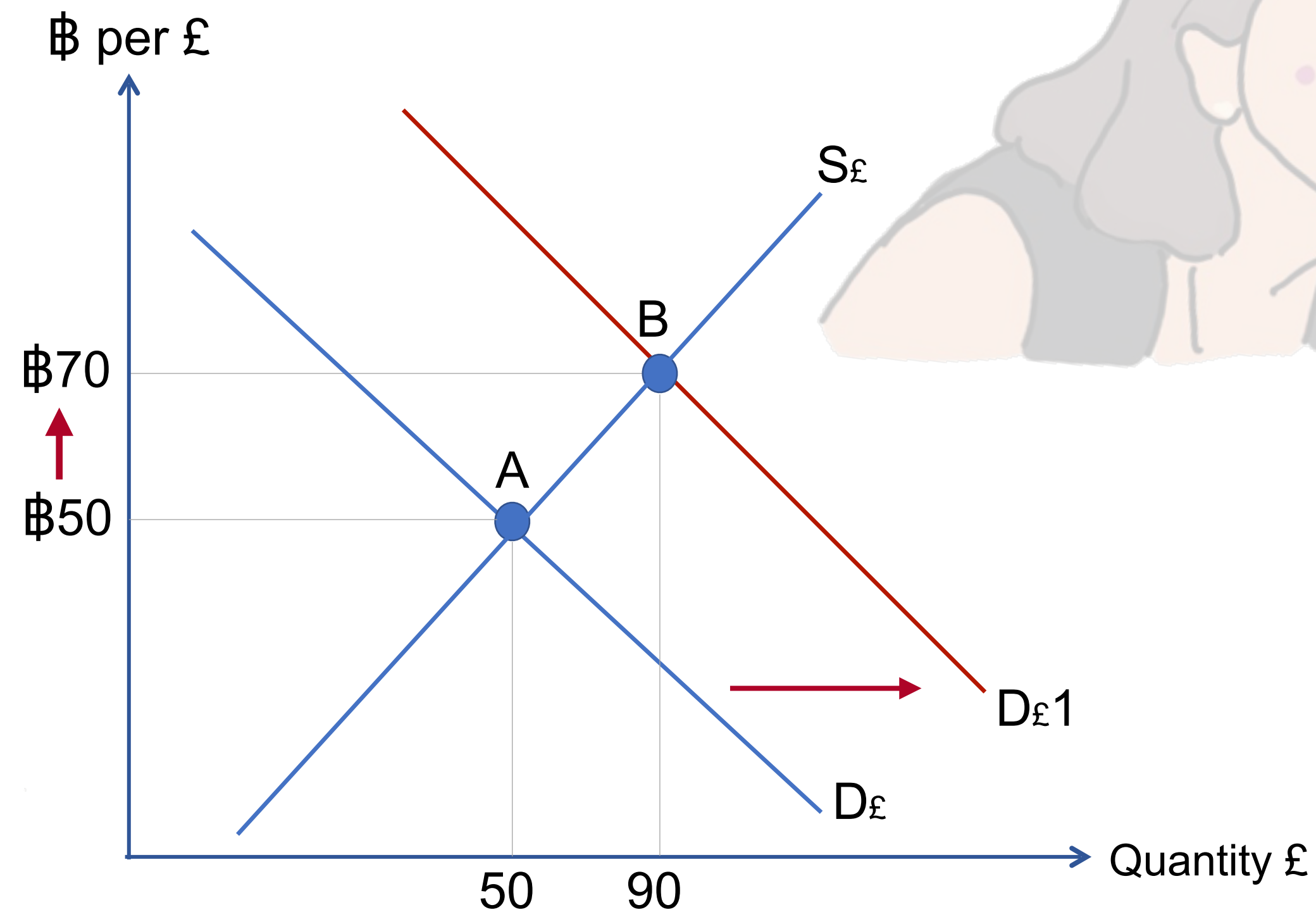
1. Floating exchange rate system : An exchange rate is determined by demand and supply of a currency.

Higher demand for £ => £ appreciated against ₩

Higher supply for £ => £ depreciated against ₩

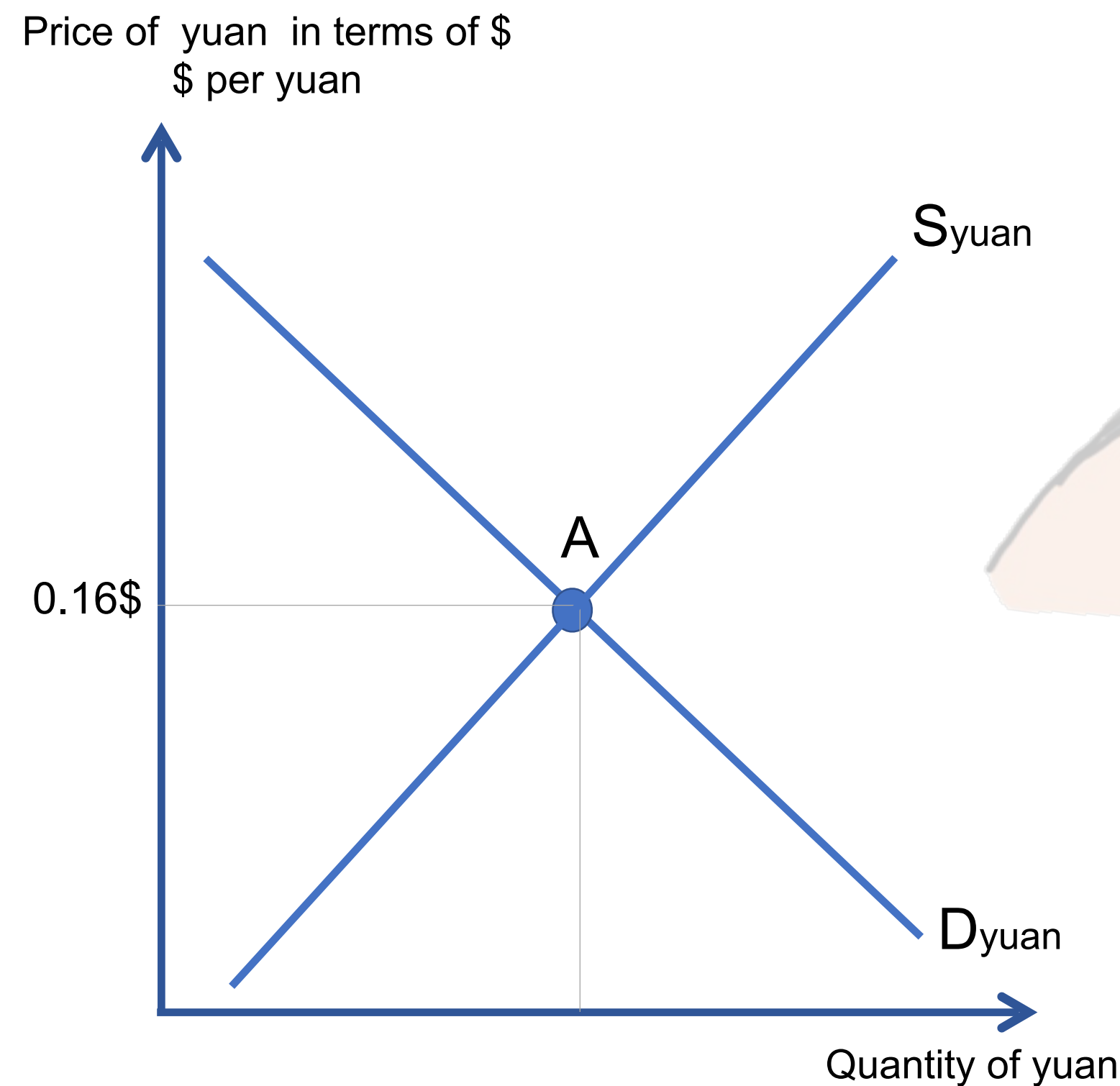
Original: 1 £ = ₩50 => New: 1 £ = ₩70

Original: 1 £ = ₩50 => New: 1 £ = ₩30



2. The determination of a foreign exchange rate

2. Fixed exchange rate system : An exchange rate is determined by central banks.



To revalue a currency (by increasing demand for the currency and reducing supply of the currency)

1. Buy the country's currency and sell foreign currency

=> Higher demand for the currency

2. Increasing interest rate

=> It creates hot money inflow to deposit money in the country.

=> Higher demand for the currency and lower supply of the currency

To devalue a currency (by decreasing demand for the currency and increasing supply of the currency)

1. Sell the country's currency and buy foreign currency

=> Higher supply of the currency

2. Decreasing interest rate

=> It creates hot money outflow to deposit money abroad.

=> Lower demand for the currency and higher supply of the currency

3. Factors influence demand and supply of the currency

Factors increase demand for pound

1. UK exports increases

=> Demand for £ increases to buy UK exports

=> £ appreciated

2. Higher interest rate in the UK

=> Hot money inflow to deposit money in domestic banks to gain higher return

=> Demand for £ increases => £ appreciated

3. Speculation

=> Speculators expected that £ will have higher value.

=> Buy £, Demand for £ increases => £ appreciated

4. Money inflow into the UK for investment in UK

=> Demand for £ increases => £ appreciated

Factors increase supply for pound

1. UK imports increases

=> Supply of £ increases to buy imported goods

=> £ depreciated

2. Lower interest rate in the UK

=> Hot money outflow to deposit money abroad to gain higher return

=> Supply of £ increases => £ depreciated

3. Speculation

=> Speculators expected that £ will have lower value.

=> Sell £, Supply of £ increases => £ depreciated

4. Money outflow from the UK to invest abroad

=> Supply of £ increases => £ depreciated

4. The consequences of a change in the exchange rate

A fall in exchange rate

Advantages of currency depreciation

Price of exports is cheaper in foreigners' view & Price of import is more expensive in domestics 'view.

1. Demand for export increases and demand for imports decreases

=> Higher export revenue and lower import expense

=> Net export increases => AD rises

=> **Balance of payment improved**

2. Production increases for exports=> National output increases

=> **Economic growth**

3. Production increases for exports => **Employment increases**

Disadvantages of currency depreciation

1. Higher net export causes **demand-pull inflation.**

2. Higher price of imports increases cost of imported raw material, causing **cost-push Inflation.**

A rise in exchange rate

Advantages of currency appreciation

Price of exports is more expensive in foreigners' view & Price of import is cheaper in domestics 'view.

1. Lower net export reduces **demand-pull inflation.**

2. Lower price of imports decreases cost of imported raw-material, reducing **cost- push Inflation.**

Disadvantages of currency appreciation

1. Demand for export decreases and demand for imports increases.

=> Lower export revenue and higher import expense

=> Net export decreases => **Balance of payment worsen**

2. Production decreases due to lower demand for exports

=> National output decreases => **Slow down economic growth**

3. Production decreases due to lower demand for exports

=> **Employment decreases**

5. Advantages and disadvantages of floating exchange rate

Floating Exchange Rate

Advantages

1. Floating exchange rate **helps balance trade.**

=> When trade deficit occurs($IM > EX$) => Currency depreciated

=> Currency depreciated makes exports become cheaper and makes imports become more expensive

=> It increases export revenue and reduces import expense.

2. Central bank **can focus on other objectives.**

=> E.g. When inflation is high, central bank can increase interest rate, without concern on exchange rate.

3. Government **does not need to hold a lot of reserve.**

Disadvantages

1. Floating exchange rate can be **fluctuated**


=> It may discourage MNCs as they cannot plan ahead.

2. It increases **speculation**. Speculators buy a currency which is expected to have higher value, resulting in higher demand for the currency and currency appreciated.

5. Advantages and disadvantages of fixed exchange rate

Fixed Exchange Rate

Advantages

1. Fixed exchange rate creates **certainty** which encourages investment from abroad and international trade.
 2. To **reduce level of speculation**
 3. Central bank can **devalue currency to stimulate exports.**
- => Currency devaluation makes exports become cheaper in foreigners' view.
- => It increases export revenue.
- 

Disadvantages

1. It has **opportunity cost** of holding a lot of reserve in order to intervene the value of currency.
2. To maintain the value of the currency, there might cause **problems on an economy**. E.g. Central bank might increase interest rate to push up value of currency but it results in economic slowdown & unemployment.

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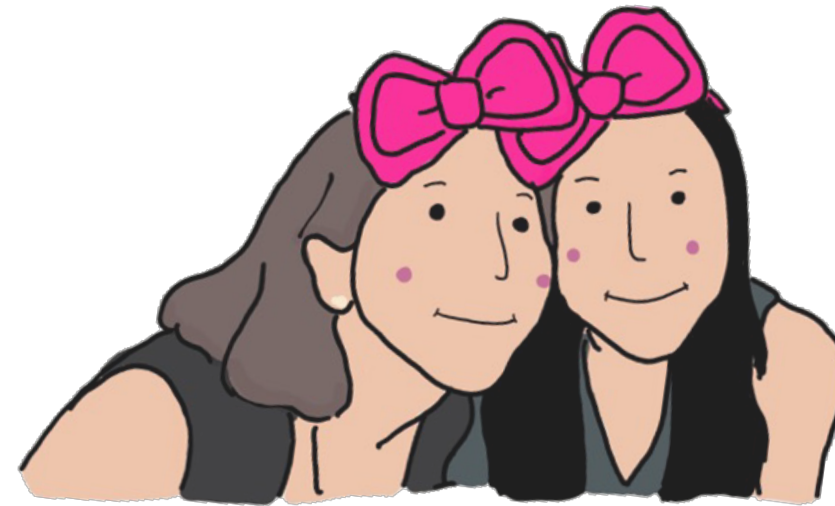
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MACROECONOMICS -

Exercise : Foreign exchange rates

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Exercise: MCQ

1.) The value of pound is appreciated against US dollar.

Which effects will this have on price of imported goods in UK's view and price of UK export of services in foreigners' view.

	Prices of imports of raw materials	Price of UK exports of services
A	More expensive	More expensive
B	More expensive	Cheaper
C*	Cheaper	More expensive
D	Cheaper	Cheaper

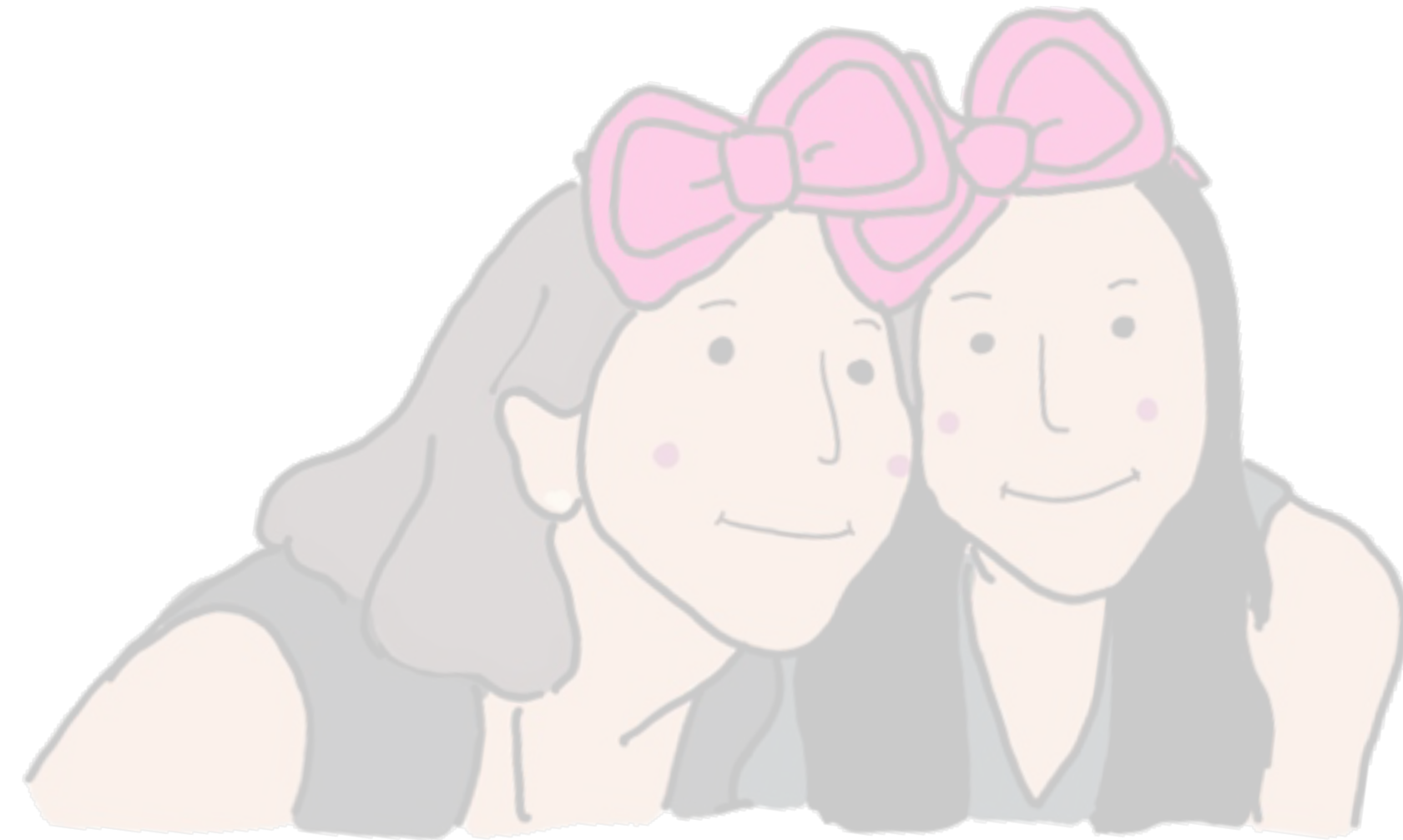
Exercise: MCQ

- 2.) What will decrease the demand for a country's currency?
- A. An increase in foreign direct investment
 - B. A decrease in interest rate*
 - C. An increase in export revenue
 - D. A decrease in import expense



Exercise: Essay

1.) Discuss whether a fall in its foreign exchange rate will always benefit a country. [8]



Exercise: Essay

1.) Discuss whether a fall in its foreign exchange rate will always benefit a country. [8]

A fall in its foreign exchange rate benefits a country.

Price of exports is cheaper in foreigners' view & Price of import is more expensive in domestic's view.

1. Demand for export increases and demand for imports decreases

=> Higher export revenue and lower import expense

=> Net export increase => AD rises => **Balance of payment improved**

2. Production increases for exports => National output increases => **Economic growth**

3. Production increases for exports => **Employment increases**

A fall in its foreign exchange rate **may not** benefit a country.

1. Higher net export causes **demand-pull inflation**.

2. Higher price of imports increases cost of imported raw material, causing **cost-push Inflation**.

3. Price of imports increases => Consumers' living standards decrease

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