Chapter 29

Exchange rate systems

Key terms

1. Adjustable peg system: an exchange rate system where currencies are fixed in value in the short term but can be devalued and revalued in the longer term
2. Depreciation of a currency: when the value of a currency falls because of free market forces or with a managed float, because of government intervention.
3. Appreciation of a currency: when the value of a currency rises because of free market forces or with a managed float, because of government intervention.
4. Exchange rate: the value of a currency when traded for another currency
5. Exchange rate systems: systems which determine the conditions under which one currency can be exchanged for another.
6. Fixed exchange rate system: a rate of exchange between at least two currencies which is constant over a period of time.
7. Floating or free exchange rate system: where the value of a currency is determined by free market forces and where the value of a currency changes from day to day
8. Foreign exchange markets: trading arrangements where currencies are Vought and sold for each other
9. Managed exchange rate system or hybrid or intermediate system: an exchange rate system where free markets determine the value of a currency but where central banks intervene from time to time to change the value of their currency
10. Nominal exchange rate: the rate at which one currency is bought and sold on the foreign exchange markets for another currency
11. Real exchange rate: the ratio of the cost of typical bundle of goods in one country compared to its cost in another country in the currencies of each country
12. Purchasing power parity theory of exchange rate: the hypothesis that long run changes in exchange rates are caused by differenced in inflation rates between countries.
13. Trade weighted exchange rate index or effective exchange rate: measure of the exchange rate of a country's currency, usually against a basket of currencies of a country's major trading partners.

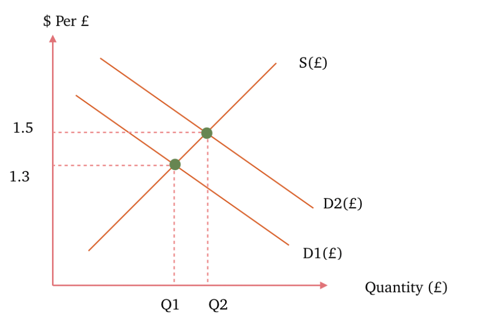
1. The exchange rate

- **Exchange rate :** The rate at which one currency can be converted into another currency.
- **Fixed exchange rate systems** : is one where a currency has a fixed value against another currency or commodity.
- **Managed exchange rate systems (Hybrid or intermediate system)** : free market forces of demand and supply help determine the exchange rate. However, gov. Also plays some part in determining the exchange rate of the currency.
- **Floating exchange rate system** : is any systems that determines the conditions under which one currency can be exchanged for another.

- **Floating exchange rate**: is determined by demand and supply of a currency.

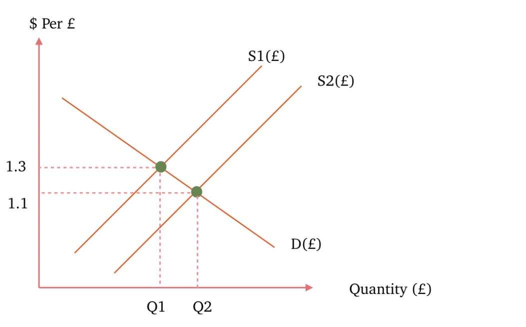
<u>The effects of an increase in demand for £</u>

- **Demand for £ ↑** ⇒ caused by higher UK exports and money inflow into the UK.
- **Demand for £ ↑** ⇒ £ has higher value or £ appreciation



<u>The effects of an increase in supply of £</u>

- **Supply of £ ↑** : when UK imports ↑ and money outflow from the UK.
- **Supply of £ ↑** : £ has lower value or £ depreciation



2. Government intervention in currency markets through

2.1 Foreign currency transaction

- When central bank would like to increase the value of a currency, it will buys its own currency in exchange for foreign currency

2.2 The use of quantitative easing

- When central bank would like to decrease the value of a currency, it can be done by QE. QE can lower interest rate. Foreign investors are discourages to invest or save money in the country which reduce demand for the country's currency, resulting in lower value of the currency.

2.3 The use of interest rate

- When central bank would like to increase the value of a currency, it will increase interest rate, this will cause hot money inflow into a country in order to deposit money and gain higher returns. This increases demand for the currency making a rise in the value of the country's currency.

3. Factors influencing on floating exchange rate

- **Depreciated currency :**

Depreciation of a currency: when the value of a currency falls because of free market forces or with a managed float, because of government intervention.

- **Appreciated currency**

Appreciation of a currency: when the value of a currency rises because of free market forces or with a managed float, because of government intervention

3.1 Relative interest rates

- Higher interest rate in the UK than other countries ⇒ hot money inflow to deposit money in banks in the UK to gain higher return ⇒ demand for £ ↑ ⇒ £ appreciation

3.2 Relative inflation rates

- Higher inflation rate in the UK than other countries ⇒ Exports become less price competitive in the world market ⇒ lower export revenue ⇒ demand for £ falls ⇒ £ depreciation

<u>3.3 Current account of the balance of payments</u>

<u>Current account deficit</u>

- Lower UK exports ⇒ demand for £ falls ⇒ £ depreciation
- Higher UK imports expense ⇒ supply of £ rises ⇒ £ depreciation

<u>3.4 Capital flight</u>

- Capital fight ⇒ supply of £ rises ⇒ £ depreciation

<u>3.5 Expectations and speculation</u>

- Speculation ⇒ buy a currency which is expected to have higher value

⇒ demand for a currency rises ⇒ £ appreciation

<u>3.6 Global factors</u>

- If a country exports oil and price of oil falls ⇒ the value of exports falls ⇒ demand for the currency falls ⇒ a currency depreciation

<u>4. Fixed exchange rate system</u>

: A fixed exchange rate system has a value determined by the gov. Or central bank compared to other countries.

: Central bank can use it reserves of gold & foreign currency to buy and sell its exchange rate against another currency.

<u>4.1 If central bank would like to increase currency (revalued currency)</u>

- When central bank would like to increase the value of a currency, it will buys its own currency in exchange for foreign currency

- When central bank would like to increase the value of a currency, it will increase interest rate, this will cause hot money inflow into a country in order to deposit money and gain higher returns. This increases demand for the currency making a rise in the value of the country's currency.

Exercise Chapter 29 and 30

Exchange rate systems and the impact of changes in exchange rates

1. In 2016 the US President promised to impose tariffs on imports of Mexico's manufactured goods. This led to uncertainty, resulting in a 20% fall in the value of Mexico's currency, the peso.

(a) Assess factors that influence the exchange rate of a currency. (15 marks)

(b) To what extent might the depreciation in Mexico's currency improve its economic performance? (25 marks)