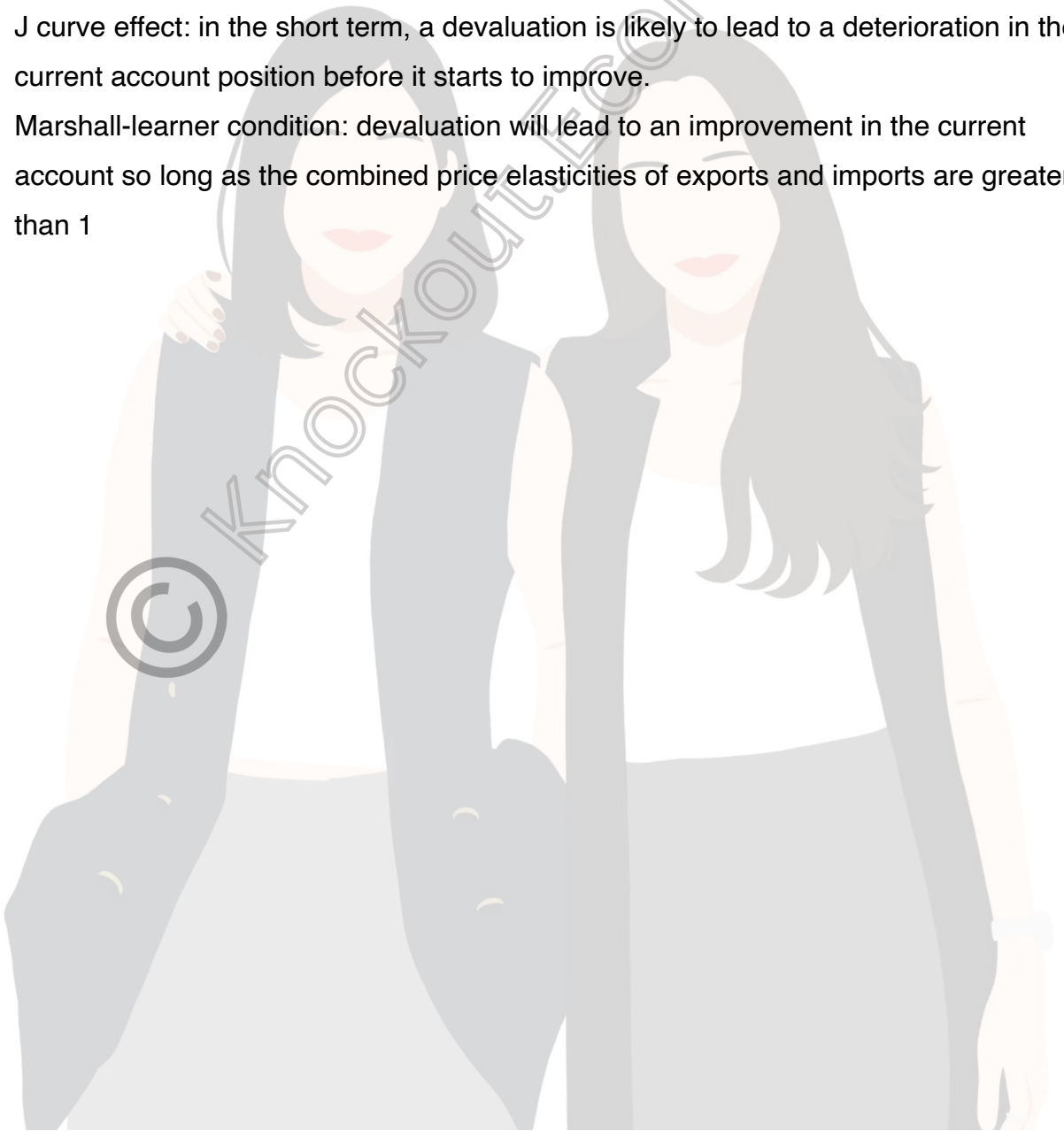
Chapter 30

The impact of changes in exchange rates

Key terms

1. 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.
2. 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. Devaluation of a currency: when a government or central bank officially fixed a new lower exchange rate for the currency in a fixed or pegged system of exchange rate.
4. Revaluation of a currency: when a government or central bank officially fixed a new higher exchange rate for the currency in a fixed or pegged system of exchange rate.
5. J curve effect: in the short term, a devaluation is likely to lead to a deterioration in the current account position before it starts to improve.
6. Marshall-learner condition: devaluation will lead to an improvement in the current account so long as the combined price elasticities of exports and imports are greater than 1



1. The impact of changes in exchange rates (Depreciation)

A fall in exchange rate or currency depreciation

Positive consequences

1. Balance of payment improved

: Price of export ↓ in foreigners 'view ⇒ Demand for export ↑ ⇒ Export revenue ↑

: Price of import ↑ in domestic's view ⇒ Demand for import ↓ ⇒ Import expense ↓

⇒ Net export↑ ⇒ Balance of Payment improved

2. Economic growth

: Domestic production increases from higher exports and higher demand for domestic goods ⇒ National output ↑ ⇒ Economic growth

3. High employment

An increase in production for exports and domestic demand create jobs and employment.

4. Foreign direct investment

A fall in the value of currency makes incentive for foreigners to invest in the country due to lower cost of production.

5. The capital and financial account of balance of payment

A fall in the value of currency makes incentive for foreigners to invest in the country due to lower cost of production. This increases money inflow into financial account of balance of payment.

Negative consequences

1.Inflation

A rise in net export leads to higher AD(C+I+G+NX) ⇒ Demand-pull inflation ↑

Currency depreciation causes price of imported raw material to rise ↑ ⇒ Cost push inflation↑

2. Currency depreciation might reflect a country's instability

E.g. BREXIT causes £ depreciation.

Devaluation / depreciation and elasticity and the Marshall-Lerner condition

- **Marshall-Lerner condition** stated that, given very specific conditions, a fall in the value of a currency will result in an improvement on the current account if the combined price elasticities of demand for exports and imports are greater than 1. If combined elasticities for export and import are less than 1, then the correct policy response to a current account deficit should be a currency revaluation.

- **J curve effect:** in the short term, a devaluation is likely to lead to a deterioration in the current account position before it starts to improve.
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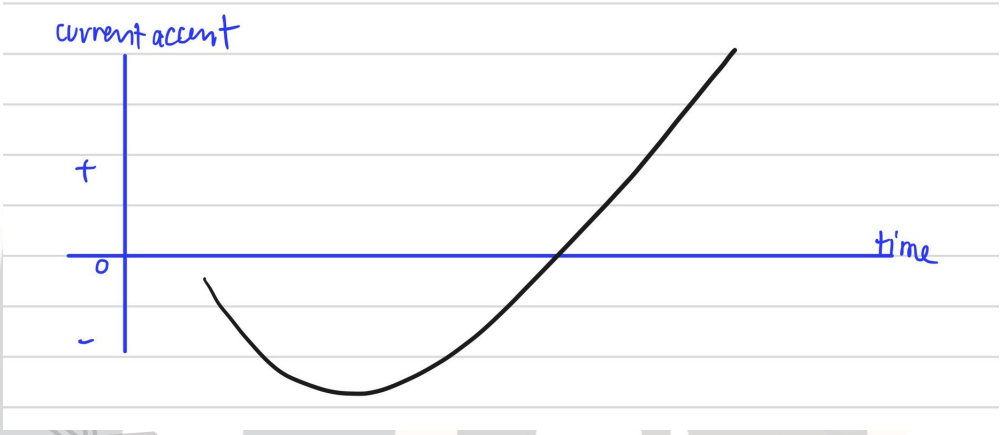

Exercise Chapter 29 and 30

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)