

Chapter 27 Exchange rates

Answers to Knowledge checks

- 27.1** With the exchange rate at $\$1 = \text{€}0.8$, $\text{€}60$ would exchange into $\$75$ (i.e. $60/0.8$).
- 27.2** If Europeans decide they want to buy fewer British goods, the demand for pounds will fall and the demand curve will shift to the left.
- 27.3** If the equilibrium rate is below the official rate, there will be excess demand for pounds, so the authorities would need to buy foreign exchange (adding to reserves) in order to release more pounds onto the market.
- 27.4** I cannot know whether recent events that you have observed have caused changes in the sterling exchange rate. However, examples in the recent past include the onset of the financial crisis in the late 2000s and the result of the Brexit referendum in 2016, which led to a sudden (and large) fall in the value of the pound.
- 27.5** Differences in inflation rates across countries are problematic in a fixed exchange rate system as they affect relative competitiveness. Countries then see a need to seek re-alignment of their currencies. Maintaining fixed exchange rates then becomes more difficult. In the case of the breakdown of the Dollar Standard, the USA had been financing the Vietnam War partly by expanding money supply. With the dollar being the base currency for the system, this led to an acceleration of inflation in many countries around the world.

Answers to Exercises and Case studies

Exercise 27.1

I cannot offer helpful comments here, as I do not know when you will be undertaking the exercise.

Exercise 27.2

- The sterling price if the firm buys in the USA is $\text{£}100,000$.
- The firm is likely to buy in the USA, as the UK price is higher at $\text{£}125,000$.
- However, if the exchange rate is devalued to $\text{£}1 = \$2$, the US price is now $\text{£}150,000$, although the dollar price is unchanged.
- The firm will now buy in the UK, as the devaluation has made British goods more competitive.
- With the improvement in competitiveness of British goods in international markets, we would expect to see an increase in the demand for exports, and a fall in demand for imports accompanied by an increase in the domestic demand for goods that are import-competing. The key question is whether British firms will be able to respond to these changes, or whether the effect will be to put pressure on domestic prices. In other words, the short-run elasticity of supply of British goods is crucial in determining the impact of devaluation on the current account of the balance of payments. It is possible that there will be a *J-curve* effect, whereby the current account improves only after a time lag.

Exercise 27.3

The three statements capture the key arguments that have been advanced in examining whether fixed or floating exchange rates are recommended for a country.

A floating exchange rate system is fairly robust in the face of external shocks, enabling adjustment to take place through movements in the exchange rate, rather than through output and

employment. Fixed exchange rates force governments to intervene to support the currency in response to an external shock, which can lead to increasing unemployment and slower growth. On the other hand, with a fixed exchange rate system, there is more certainty about future trading conditions — unless there is a devaluation, of course. Some countries in the euro area have struggled in the crisis and subsequent recession because they were unable to adopt independent policies — being a member of the euro area means that monetary policy is set by the European Central Bank, leaving little scope for manoeuvre by individual nations. The monetary policy stance that is appropriate for Germany may not suit Greece.

You should discuss these issues with your fellow students, and come to a view about the questions.

Case study 27.1

Balancing the balance of payments

- a** From China's point of view, there are some clear benefits, as mentioned in the passage — the low exchange rate means that China's exports remain highly competitive, and makes China an attractive destination for foreign direct investment. However, there are some risks attached to this strategy. China had been growing very rapidly and needed to export to find a market for its expanding production. If the economy were to slow down, this could prove costly for the domestic economy. Furthermore, the high dependence on exports had meant that domestic consumption had taken a relatively small share of GDP, so not all of China's population had been benefiting from the growth.

Some commentators have therefore argued that China should have allowed its exchange rate to appreciate partly to enable the economy to grow at a steadier pace, and partly to enable more domestic consumption. Another possible risk is that by accumulating so many US government securities, China becomes vulnerable to an adverse movement in the value of the US dollar, which could reduce the value of China's holdings. In the period since 2006, China has allowed its currency to appreciate — but only relatively slowly.

- b** From the USA's point of view, China's actions allowed the USA to run a large and persistent current account deficit. Furthermore, with China demanding US Treasury Bills, interest rates in the USA had been relatively low, which facilitated a consumer boom based on borrowing. However, there has been intense lobbying from within the USA from people who argue that cheap imports from China have led to a loss of jobs in the USA. This is a contentious issue, as in general economists have argued that there are potential gains to be made from international trade.
- c** An indirect effect of the strategy was that US interest rates were lower than they would otherwise have been. This may have contributed to high consumer spending and the housing boom, which built into a bubble that was bound to burst at some point.
- d** The actions of President Trump illustrate the legacy. He has accused China of adopting policies that have affected jobs in the USA. In response, he imposed tariffs on a wide range of goods imported from China, later extending these to Europe, provoking further response.

Answers to end-of-chapter questions

A Multiple-choice questions

- 1 c. £1 was worth \$0.90 and is now worth \$1.05
- 2 a. A floating exchange rate system
- 3 d. A decrease in imports and an increase in exports

B Knowledge and understanding questions

- 4 An exchange rate is the price of one currency in terms of another.

A full explanation of the exchange rate	2 marks
A vague or partial explanation of the exchange rate	1 mark

- 5** The price is determined through the interaction of the demand for the currency and the supply of the currency. The price is found at the interaction (equilibrium) point between demand and supply.

An explanation of how the price of a currency is determined in a floating exchange rate system	up to 2 marks
A diagram showing how the price of a currency is determined in a floating exchange rate system	up to 2 marks

- 6** Advantages may include:

- Less need for reserves of currency
- Can be used to correct imbalances
- Can help to bring the economy into macroeconomic equilibrium
- Lowers the risk of currency speculation

Two advantages explained	4 marks
One advantage explained AND one advantage identified	3 marks
One advantage explained OR two advantages identified	2 marks
One advantage identified	1 mark

C Stimulus response question

- 7 a** A fixed exchange rate system is a system in which the government of a country agrees to fix the value of its currency in terms of that of another country.

A full explanation of a fixed exchange rate system	2 marks
A vague or partial explanation of a fixed exchange rate system	1 mark

b

AO1 Knowledge	1 mark
AO2 Application	1 mark
AO3 Analysis	5 marks
AO4 Evaluation	5 marks

systems

Knowledge (1 mark) is likely to include:

- Exchange rate

Application (1 mark) is likely to include:

- Application to a pegged exchange rate system between the krone and the euro

Analysis (5 marks) is likely to include:

Analysis of the possible advantages of a pegged exchange rate system, for example:

- May give confidence to business
- May encourage investment
- Allows planning for the future

Analysis of the possible disadvantages of a pegged exchange rate system, for example:

- Opportunity cost of pursuing other macroeconomic objectives
- May cause macroeconomic disequilibrium
- May lead to a current account imbalance
- May dominate monetary policy

Evaluation (5 marks) is likely to include:

- Evaluation that the advantages may not occur
- Evaluation that the disadvantages may not occur

A judgement of the possible advantages and disadvantages to Denmark of pegging the value of the krone to the euro

D Essay question

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AO1 Knowledge	3 marks
AO2 Application	4 marks
AO3 Analysis	6 marks
AO4 Evaluation	7 marks

Knowledge (3 marks) likely to include:

- Exchange rates
- Depreciation of a currency
- Balance of payments
- Imports and exports

Application (4 marks) is likely to include:

- Application to the UK economy

Analysis (6 marks) is likely to include:

Analysis of the consequences of a depreciation of the pound, for example:

- Imports may become more expensive, which may lead to an increase in demand for domestic goods, increasing *AD*
- Exports may become less expensive, leading to an increase in *AD*
- Increased international competitiveness

Evaluation (7 marks) is likely to include:

Evaluation that the consequences may not occur in the UK economy, for example:

- Increases in *AD* may not lead to an increase in real GDP (classical *LRAS*, or economy at full employment)
- Increases in *AD* may only have an inflationary effect

- Depends upon the size of the depreciation
- Depends upon future expectations of the macroeconomy

A judgement of the likely consequences to the UK economy of a depreciation of the pound