4.1.8 Exchange rates

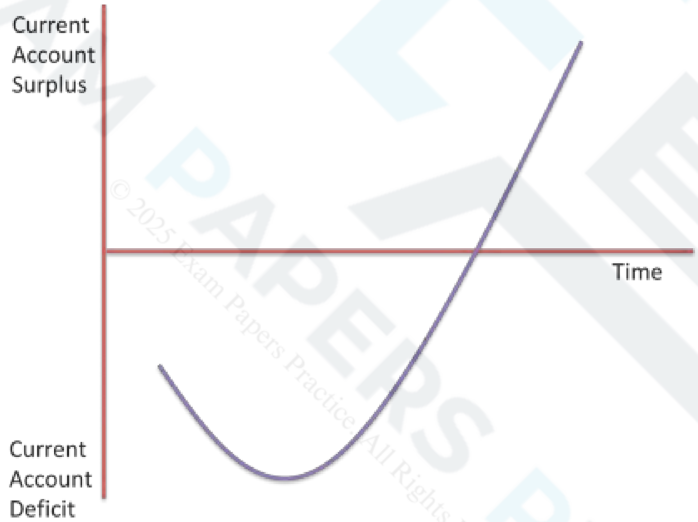
a. *Exchange rate systems:*
  - *floating*
  - *fixed*
  - *managed*

b. *Distinction between revaluation and appreciation of a currency*
c. *Distinction between devaluation and depreciation of a currency*
d. *Factors influencing floating exchange rates*
e. *Government intervention in currency markets through foreign currency transactions and the use of interest rates*
f. *Competitive devaluation/depreciation and its consequences*
g. *Impact of changes in exchange rates:*
  - *the current account of the balance of payments (reference to Marshall-Lerner condition and J curve effect)*
  - *economic growth and employment/unemployment*
  - *rate of inflation*
  - *foreign direct investment (FDI) flows*

- Floating exchange rate: the value of the exchange rate is determined by the forces of supply and demand
- Fixed exchange rate: the value of the exchange rate is determined by the government or central bank
- Managed exchange rate: a combination of the characteristics of fixed and floating exchanges rates. The currency fluctuates, but the central bank buys and sells currencies to try and influence their exchange rate
- Revaluation: when a country's value to adjusted relative to its baseline asset
- Appreciation: when the value of a currency increases
- Depreciation: when the value of a currency falls relative to another currency, in a floating exchange rate system
- Devaluation: when the value of a currency is officially lowered in a fixed exchange rate system
- Factors influencing floating exchange rates:
  - Inflation: lower inflation makes exports competitive which increases demand for the currency
  - Speculation: if speculators think the value of a currency will appreciate, demand will increase in the present
  - Other currencies
  - Government finances: high levels of debt and a risk of defaulting causes a currency to depreciate since investors lose confidence
  - Balance of payments: a current account deficit causes capital outflows so the currency depreciates
  - International competitiveness: an increase in competitiveness increases demand for exports which increases demand for the currency
- Government intervention in currency markets:

- Interest rates: higher interest rates attract capital inflows which causes an appreciation
- Quantitative easing: it increases the supply of currency and creates inflation so reduces demand for a currency
- Foreign currency transactions: buying and selling foreign currency to manipulate the domestic currency

- Impacts of a competitive devaluation/ depreciation:
  - Exports are cheaper and imports more expensive so economic growth and the trade balance could improve
  - The balance of payments wouldn't adjust to external shocks
  - It can be expensive for a government to hold large amount of foreign exchange reserves
  - It depends on other factors such as the demand from trading partners
- Marshall-Learner condition: a devaluation in a currency only improves the balance of trade if the sum of the long run export and import demand elasticities are greater than one



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- J-curve effect: when the currency is devalued, there may be a time lag in changing the volume of exports and imports. This could be due to trade contracts and the price inelasticity of demand for imports in the short run. Therefore, at first imports become more expensive so the total value of imports increases, which worsens the deficit. Eventually, the value of exports decreases, which leads to a reduction in the trade deficit
- A depreciation in the currency causes inflation because the price of imported raw materials increases and AD will be increasing due to the higher amount of exports
- A depreciation in the currency means wages and production costs have fallen which makes the country more internationally competitive so it attracts more FDI