### **4.5 Exchange Rates**

#### **2 Markers:**

**Q1:** Define exchange rate.
**A1:**The exchange rate is the price of one country’s currency in terms of another currency. It indicates how much of one currency is needed to buy a unit of another currency.

**Q2:** What is the difference between a fixed and floating exchange rate?
**A2:**A fixed exchange rate is when a country’s currency value is tied to another currency or a basket of currencies, while a floating exchange rate is determined by market forces, where the value of a currency is allowed to fluctuate based on demand and supply.

#### **4 Markers:**

**Q1:** Explain two factors that can influence a country’s exchange rate.
**A1:**

1. **Inflation Rates:** Countries with lower inflation rates than their trading partners will see an appreciation of their currency due to higher purchasing power of their goods and services, attracting foreign demand.
2. **Interest Rates:** Higher interest rates can attract foreign capital as investors seek higher returns, causing an appreciation in the value of the domestic currency.

**Q2:** Discuss the advantages and disadvantages of a floating exchange rate system.
**A2:
Advantages:**

1. **Automatic Adjustment Mechanism:** A floating exchange rate system adjusts automatically to reflect changes in the economy, such as shifts in demand for exports or changes in capital flows.
2. **Monetary Policy Independence:** Countries can pursue independent monetary policies to manage inflation, interest rates, and economic growth without worrying about defending a fixed exchange rate.

**Disadvantages:**

1. **Exchange Rate Volatility:** Currency values can fluctuate significantly, which creates uncertainty for international trade and investment.
2. **Speculative Attacks:** A floating exchange rate system can lead to speculative attacks, where traders bet against a currency, destabilizing its value.

#### **6 Markers:**

**Q1:** Assess the effect of a depreciation in the exchange rate on the economy.
**A1:**A depreciation in the exchange rate makes a country's exports cheaper for foreign buyers, increasing demand for those goods and services, which can boost domestic industries. It can also make imports more expensive, potentially reducing the demand for foreign goods and encouraging domestic production. However, a weaker currency can lead to higher import prices, which may increase inflation and reduce the purchasing power of consumers. Additionally, countries with significant foreign-denominated debt may find it more difficult to service their debt, further impacting the economy.
**Example:** In 2015, the depreciation of the Chinese yuan led to increased exports, helping to sustain growth despite global economic slowdown.

**Q2:** Explain the role of central banks in influencing exchange rates.
**A2:**Central banks play a significant role in influencing exchange rates through both monetary policy and direct interventions. When a central bank wants to influence its currency’s value, it can adjust interest rates or engage in open market operations to influence currency supply. For instance, increasing interest rates can attract foreign capital inflows, leading to currency appreciation. In addition, central banks can intervene directly in the foreign exchange market by buying or selling their own currency to stabilize its value. This is especially common in countries with fixed or managed exchange rate systems.
**Example:** The Swiss National Bank has intervened multiple times to prevent the Swiss franc from appreciating too much, which could harm the Swiss export sector.

#### **8 Markers:**

**Q1:** Evaluate the advantages and disadvantages of a fixed exchange rate system.
**A1:
Advantages:**

1. **Stability and Predictability:** Fixed exchange rates provide stability and predictability, reducing uncertainty for businesses and investors. Companies can engage in international trade without worrying about fluctuations in currency values, which encourages investment and trade.
2. **Inflation Control:** By linking the domestic currency to a low-inflation currency (such as the US dollar), a country can reduce its own inflation rate. This is particularly beneficial for countries with a history of high inflation.
**Example:** Hong Kong’s currency has been pegged to the US dollar since 1983, helping to keep inflation rates low and promoting stability in trade relations.
**Disadvantages:**
3. **Limited Flexibility:** Fixed exchange rates limit the ability of a country to adjust to economic shocks. In the case of an economic downturn or sudden capital flight, countries with fixed exchange rates cannot easily devalue their currency to boost exports or stimulate demand.
**Example:** The 1997 Asian Financial Crisis affected countries like Thailand, which had a fixed exchange rate system, and they struggled to respond to the crisis effectively.
4. **Vulnerability to Speculative Attacks:** A fixed exchange rate system is vulnerable to attacks by speculators who may believe that the peg is unsustainable. If speculators drive the currency below its pegged value, it can lead to a financial crisis and depletion of foreign reserves.
**Example:** The 1992 UK currency crisis, known as "Black Wednesday," saw speculative attacks on the pound, forcing the UK to withdraw from the European Exchange Rate Mechanism (ERM).

#### **10 Markers:**

**Q1:** Assess the effects of exchange rate fluctuations on multinational corporations (MNCs).
**A1:**

1. **Profitability and Revenue:** Exchange rate fluctuations directly affect MNCs' revenues. When a company’s home currency appreciates, the value of foreign revenues decreases when converted back into the home currency, reducing profitability. Conversely, a depreciation increases the value of foreign income. MNCs may face reduced profitability in markets where currency fluctuations are volatile.
**Example:** A US-based company like McDonald's generates a significant portion of its revenue from Europe. If the euro weakens against the dollar, McDonald’s foreign revenues will decline when converted into US dollars.
2. **Competitiveness in International Markets:** A weak currency makes a company's products more competitive abroad by lowering their prices in foreign markets. However, if the company’s home currency strengthens, it may lose competitive advantage.
**Example:** If the Japanese yen weakens, Toyota’s cars become cheaper for US consumers, potentially increasing market share. On the other hand, a stronger yen may make Toyota cars more expensive, reducing demand in foreign markets.
3. **Hedging and Risk Management:** MNCs use hedging strategies to mitigate the risks posed by exchange rate fluctuations. These strategies include using financial instruments like forward contracts, options, and swaps to lock in exchange rates for future transactions. While hedging reduces risk, it may also incur costs, which could reduce overall profitability.
**Example:** A US-based firm may enter into a forward contract to lock in an exchange rate for purchasing goods from Japan, protecting itself from currency fluctuations.
4. **Cost Structure and Supply Chains:** Exchange rate fluctuations affect the cost of importing materials and goods, impacting the cost structure for MNCs. If the domestic currency depreciates, the cost of imported goods rises, increasing production costs. Conversely, an appreciating currency may lower the cost of imports, making production cheaper.
**Example:** Apple, which imports components from multiple countries, may face higher costs when the US dollar weakens against the currencies of its suppliers in Japan and South Korea.

#### **15 Markers:**

**Q1:** To what extent does a country's exchange rate policy affect its economic growth?
**A1:**The exchange rate policy of a country can significantly impact its economic growth. Exchange rate policies affect trade, investment, inflation, and capital flows, all of which are critical drivers of economic performance. Countries can adopt a fixed, floating, or managed exchange rate system, and each system carries its own set of advantages and disadvantages in influencing economic growth.

1. **Impact on Trade Balance:** Exchange rate policy directly affects a country’s trade balance, a critical component of economic growth. A devaluation of the domestic currency makes exports cheaper and imports more expensive, boosting demand for domestic goods and services. This can increase export revenues and domestic production, ultimately stimulating economic growth. Conversely, an overvalued currency can hurt exports, leading to a trade deficit and potentially reducing economic activity.
**Example:** In the 1990s, the Chinese government maintained a fixed exchange rate to keep the yuan undervalued. This policy helped increase China’s exports, fueling its rapid economic growth.
2. **Capital Flows and Foreign Investment:** A stable and predictable exchange rate can attract foreign investment, as investors seek to avoid exchange rate risk. In countries with fixed or managed exchange rates, investors can have more confidence in the long-term stability of their investments. A strong currency can also encourage foreign capital inflows. On the other hand, countries with volatile currencies may see reduced investment, which can hinder long-term growth.
**Example:** The introduction of the euro in 1999 was designed to stabilize exchange rates within the European Union, boosting investor confidence and leading to increased foreign investment.
3. **Inflationary Pressures:** Exchange rate policies can influence inflation levels, which in turn affects economic growth. A depreciation of the currency leads to higher import prices, contributing to inflationary pressures. In the short run, this can hurt consumer purchasing power, reduce demand, and slow economic growth. On the other hand, a deflationary environment created by an appreciating currency can harm domestic industries by reducing competitiveness and demand.
**Example:** In 2008, the global financial crisis caused many countries to experience sharp declines in their exchange rates, leading to increased inflation and higher costs for imports, which negatively impacted growth in emerging economies.
4. **Monetary Policy and Policy Autonomy:** Countries with fixed exchange rate systems have limited autonomy in monetary policy. Since the country must maintain its peg, the central bank may have to raise or lower interest rates to defend the exchange rate, which could conflict with domestic economic objectives. Countries with floating exchange rate systems have greater flexibility in pursuing independent monetary policies tailored to domestic economic conditions.
**Example:** During the 1997 Asian Financial Crisis, countries like Thailand and Indonesia that had fixed exchange rate systems were forced to devalue their currencies under pressure from speculators, leading to significant economic instability.
5. **Hedging and Risk Management:** Exchange rate volatility can lead to increased risk for businesses, reducing investment in the economy. Companies engage in hedging strategies to protect themselves from adverse currency movements, but this can involve significant costs. Volatile exchange rates can also deter long-term foreign investment, as businesses prefer stability to reduce risks.
**Example:** During the Brexit referendum in 2016, the British pound depreciated sharply, causing uncertainty for investors and businesses that rely on the stability of the currency for their operations.

In conclusion, a country’s exchange rate policy plays a crucial role in shaping its economic growth trajectory. While some exchange rate policies may support growth through increased exports and investment, others may introduce inflationary pressures and instability, limiting the ability to foster sustainable economic growth.