

The background of the slide features a light blue to dark blue gradient. Scattered across this gradient are numerous water droplets of various sizes, some appearing as simple circles and others as more complex, rounded shapes with highlights and shadows, giving them a three-dimensional appearance.

DEFINITION AND MEASUREMENT OF EXCHANGE RATES

EXCHANGE RATE: THE PRICE OF ONE CURRENCY IN TERMS OF ANOTHER CURRENCY

NOMINAL FOREIGN EXCHANGE, BILATERAL EXCHANGE RATE

- TRADE WEIGHTED EXCHANGE RATE
- REAL EFFECTIVE EXCHANGE RATE



TRADE WEIGHTED EXCHANGE RATE

- *THE PRICE OF ONE CURRENCY AGAINST A BASKET OF CURRENCIES*
- TO MEASURE GENERAL CHANGE IN COUNTRY'S FOREIGN EXCHANGE RATE

REAL WEIGHTED EXCHANGE RATE

- *A CURRENCY'S VALUE IN TERMS OF ITS REAL PURCHASING POWER*
- TO ASSESS CHANGES IN COMPETITIVENESS OF A COUNTRY'S PRODUCTS IN GLOBAL MARKET

$$\text{The real exchange rate} = \frac{\text{nominal exchange rate} \times \text{domestic price index}}{\text{foreign exchange rate}}$$

FLOATING EXCHANGE RATE

DETERMINED BY THE MARKET FORCES OF DEMAND AND SUPPLY - APPRECIATION, DEPRECIATION

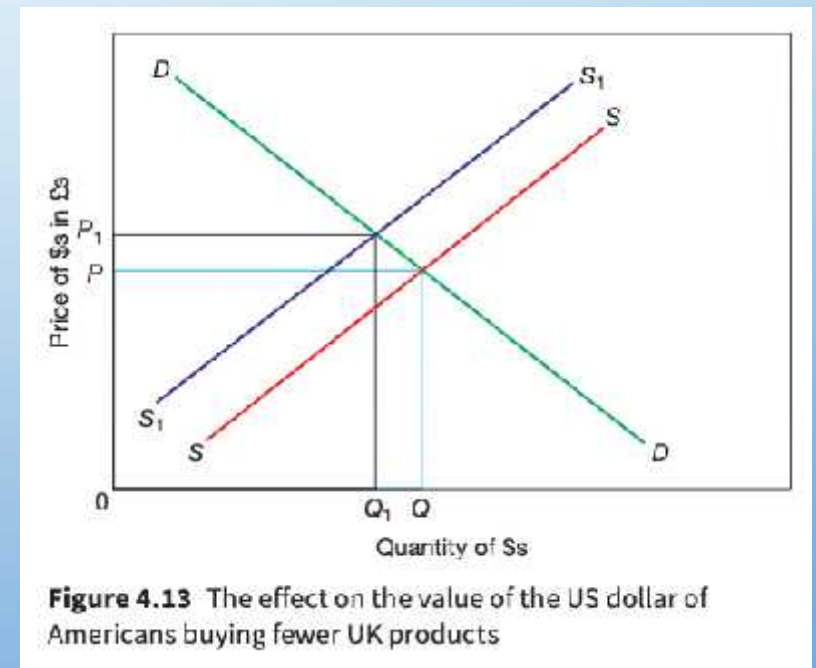
- BUY GOODS AND SERVICES FROM THE COUNTRY
- INVEST IN COUNTRY
- MAKE PROFIT THROUGH EXCHANGE RATE CHANGE

ADV: -RESTORE BALANCE ON CURRENT ACCOUNT

-GOVERNMENT CAN CONCENTRATE ON OTHER THINGS

DISADV: -FLUCTUATE SIGNIFICANTLY

-GOVERNMENT RELY ON FALL IN RATE



FIXED EXCHANGE RATE SYSTEM

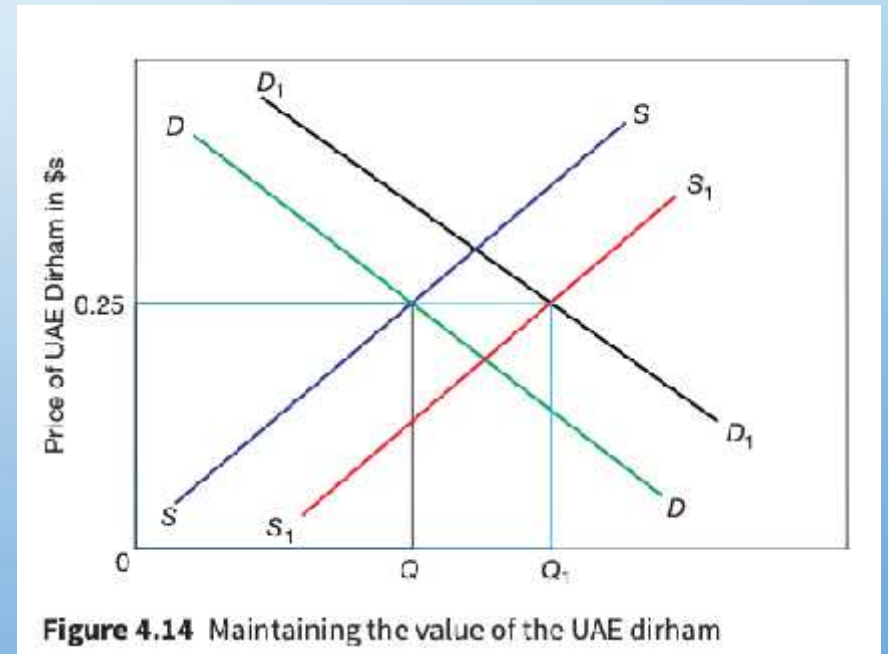
SET BY GOVERNMENT AND MAINTAINED BY THE CENTRAL BANK – REVALUATION, DEVALUATION

- INCREASE IN RATE – **ATTRACTS HOT MONEY FLOWS** (TO TAKE ADV OF CHANGES IN RATES)

ADV: - AVOIDS FLUCTUATIONS

-KEEP INFLATION LOW

DISADV: -SACRIFICE OTHER GOVERNMENT AIMS



MANAGED FLOAT

INFLUENCED BY STATE INTERVENTION – COMBINES FLOATING AND FIXED EXCHANGE RATES FEATURE

- HAS UPPER, LOWER LIMITS

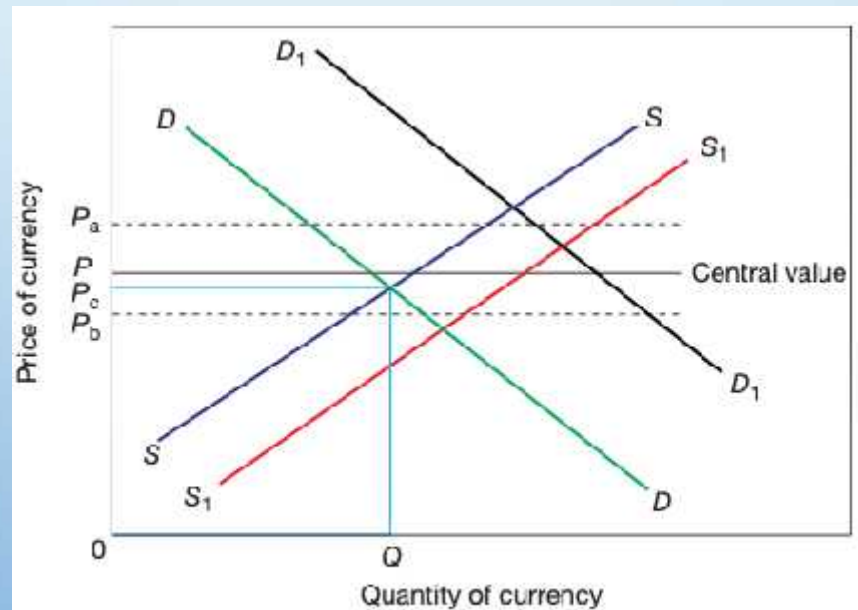


Figure 4.15 A managed float

THE FACTORS INFLUENCING CHANGES IN FOREIGN EXCHANGE RATES

1. CHANGE IN DEMAND AND SUPPLY
2. INTEREST RATE
3. IMPORT, EXPORT VALUE
4. TOURISM
5. GOVERNMENT DECISION

MARSHALL-LERNER CONDITION

- REQUIREMENT FOR A FALL IN EXCHANGE RATE TO BE SUCCESSFUL IN REDUCING CURRENT ACCOUNT DEFICIT
- SUM OF THE PED FOR EXPORTS AND IMPORTS MUST BE GREATER THAN 1

An illustration of the Marshall-Lerner condition

Initially $\text{£}1 = \text{US}\$1.5$

- 40 products, which would sell at $\text{£}10$ each in the home market, sell for $\$15$ in the US. Export revenue = $\text{£}400$ ($\$600$).
- 50 imports from the US, which sell in the US at $\$30$, are purchased in the UK at $\text{£}20$ each. Import expenditure = $\text{£}1,000$ ($\$1,500$).
- Deficit = $\text{£}400 - \text{£}1,000 = \text{£}600$.

Then the pound sterling falls in value to $\text{£}1 = \$1$.

- PED for exports = 0. Price in US falls to $\$10$ each. Total export revenue is now $40 \times \$10 = \400 which is now converted into $\text{£}400$, leaving export revenue in pounds sterling unchanged.
- PED for imports = -1.2 . Price of the $\$30$ product will rise to $\text{£}30$, a 50% increase. Demand falls by 60% to 20. Total import expenditure now equals $\text{£}600$.
- The deficit is now $\text{£}400 - \text{£}600 = \text{£}200$. It has fallen by $\text{£}400$.

J-CURVE EFFECT

- FALL IN EXCHANGE RATE CAUSING AN INCREASE IN A CURRENT ACCOUNT DEFICIT BEFORE IT REDUCES IT DUE TO THE TIME IT TAKES FOR DEMAND TO RESPOND
- TAKES TIME TO RECOGNISE THE PRICE CHANGES

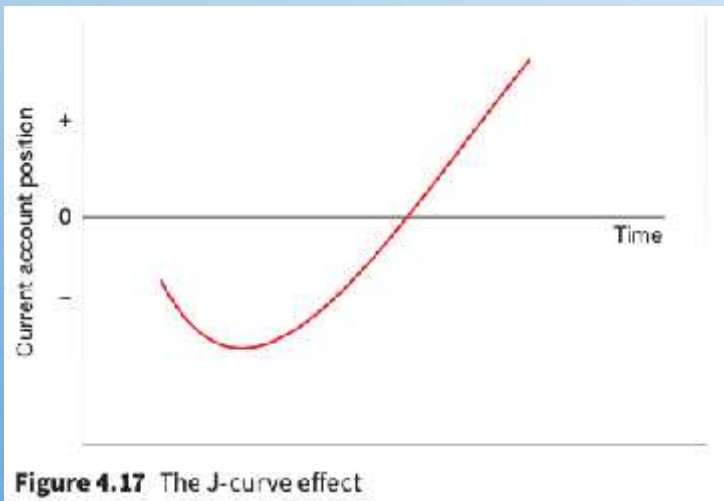


Figure 4.17 The J-curve effect

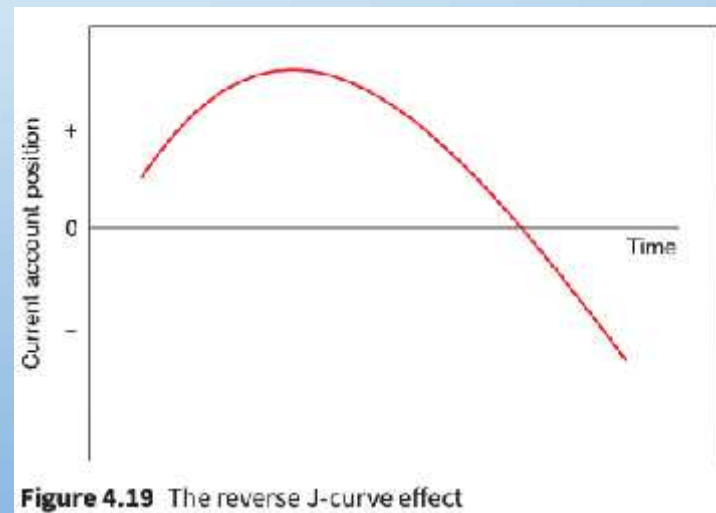


Figure 4.19 The reverse J-curve effect

EFFECT ON DOMESTIC & EXTERNAL ECONOMY

DEPRECIATION/ DEVALUATION

- EXPORT CHEAPER/IMPORT EXPENSIVE
- INCREASE AD, LOWER UNEMPLOYMENT, GROWTH IN ECONOMY
- RISE IN INFLATION-WORKS IN FULL CAPACITY, RISE IN IMPORTED RAW MATERIAL
- REDUCE CURRENT ACCOUNT DEFICIT- $PED > 1$

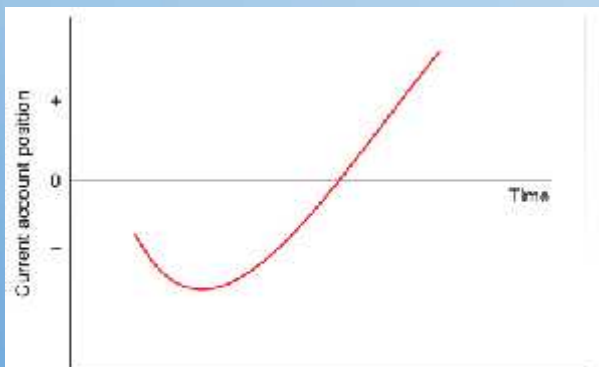


Figure 4.17 The J-curve effect

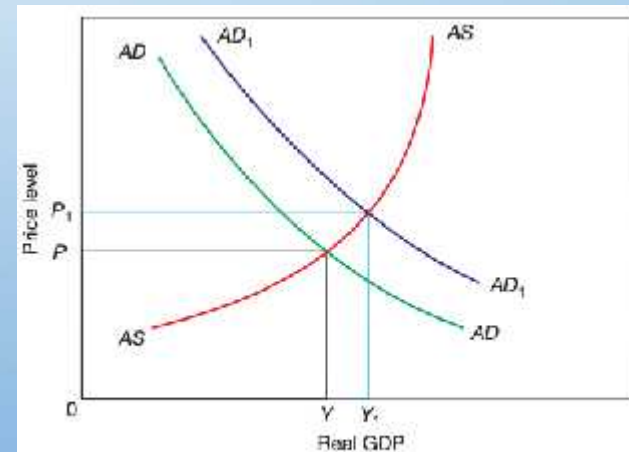


Figure 4.16 The effect of a rise in net exports

EFFECT ON DOMESTIC & EXTERNAL ECONOMY

APPRECIATION/ REVALUATION

- MAKE EXPORT EXPENSIVE/IMPORT CHEAPER
- LOWER AD, RISE IN UNEMPLOYMENT, SLOWDOWN ECONOMY
- REDUCTION IN INFLATION
- REDUCE CURRENT ACCOUNT SURPLUS-

