**CASES STUDY DISCUSSION QNS: Discussion questions**

1. What is the difference between real and nominal exchange rates? Explain citing examples from the case study above and other relevant cases you know of?

*It is customary to distinguish nominal exchange rates from real exchange rates. Nominal exchange rates are established on currency financial markets called "forex markets", which are similar to stock exchange markets. Rates are usually established in continuous quotation, with newspaper reporting daily quotation (as average or finishing quotation in the trade day on a specific market). Central bank may also fix the nominal exchange rate.*

*Real exchange rates are nominal rate corrected somehow by* [*inflation*](http://www.economicswebinstitute.org/glossary/inflat.htm) *measures. For instance, if a country A has an inflation rate of 10%, country B an inflation of 5%, and no changes in the nominal exchange rate took place, then country A has now a currency whose real value is 10%-5%=5% higher than before**. In fact, higher prices mean an appreciation of the real exchange rate, other things equal.*

1. Why is exchange rate between the Yuan and the Dollar so important to America? Explain.
2. If Kenya were an export oriented economy, would it be advisable to have a strong or a weak currency relative to foreign currency? Explain citing relevant examples.
3. Discuss the different exchange rate regimes applied by governments.

*The concept of exchange rate regime may be explained as the method that is employed by the governments in order to administer their respective currencies in the context of the other major currencies of the world. The* [*foreign exchange market*](http://www.economywatch.com/exchange-rate/regime.html) *is pretty important in this case as well.   
  
Exchange rate regime has often been likened to monetary policies and it may be concluded that both the processes are actually dependent on a lot of similar factors.   
  
There are some basic exchange rate regimes that are used nowadays – the floating exchange rate, the pegged float exchange rate and the fixed or pegged exchange rate. In case of the floating exchange rate regime, the values of the* [*currencies*](http://www.economywatch.com/exchange-rate/regime.html) *are influenced by the movements in the financial market.*

***FLOATINGEXCHANGERATES*** *The floating rates are extensively used in most countries of the world. Some common examples of the floating exchange rates would be the British pound, United States dollar,* [*Japanese Yen*](http://www.economywatch.com/exchange-rate/regime.html) *and Euro.*

*Under the free float system, the Value of the currency is determined solely by market demand for and supply of the currency in the foreign exchange market.*

* *Trade flows and capital flows are the main factors affecting the exchange rate*
* *In the long run it is the macro economic performance of the economy (including trends in competitiveness) that drives the value of the currency*
* *No pre-determined official target for the exchange rate is set by the Government. The government and/or monetary authorities can set interest rates for domestic economic purposes rather than to achieve a given exchange rate target*
* *It is rare for pure free floating exchange rates to exist - most governments at one time or another seek to "manage" the value of their currency through changes in interest rates and other controls*

*The dirty float or a managed float is where the governments always step in to address any excesses in the changes of value.   
  
There are three types of pegged floats – the crawling bands, pegging with horizontal bands and crawling bands. In case of the crawling bands the rate is permitted to fluctuate within a particular band or limit and the movements are based on a particular central value. This central value is adjusted at definite periods. The entire exercise is performed in a controlled manner. In case of the crawling pegs the rates of exchange stay fixed. In case the rates are pegged with horizontal bands the rate would be allowed to move within a specified limit or band, which is 1% more than the band.*

***FIXEDEXCHANGERATESYSTEM*** *In case of the fixed exchange rate regimes or the pegged exchange rate, as it is also known, the rates are meant to be converting directly to some other currency. At times, in case of the pegged exchange rate, the currency may be attached to a group of* [*currencies*](http://www.economywatch.com/exchange-rate/regime.html) *or even precious metals like gold.*

***Advantages of Fixed Exchange Rates (disadvantages of floating rates)***

*Fixed rates provide greater certainty for exporters and importers and under normally circumstances there is less speculative activity - although this depends on whether the dealers in the foreign exchange markets regard a given fixed exchange rate as appropriate and credible. Sterling pound came under intensive speculative attack in the autumn of 1992 because the markets perceived it to be overvalued and ripe for a devaluation.*

*Fixed exchange rates can exert a strong discipline on domestic firms and employees to keep their costs under control in order to remain competitive in international markets. This helps the government maintain low inflation - which in the long run should bring interest rates down and stimulate increased trade and investment.*

***Countries with different exchange rate regimes***

*Countries with fixed exchange rates often impose tight controls on capital flows to and from their economy. This helps the government or the central bank to limit inflows and outflows of currency that might destabilise the fixed exchange rate target,*

*The Chinese Yuan is essentially fixed using a basket of currencies- including the euro and the US dollar. Currency transactions involving trade in goods and services are allowed full currency convertibility. But capital account transactions are tightly controlled by the State Administration of Foreign Exchange.*

*The Hungarians have a semi-fixed exchange rate against the Euro with the forint allowed to move 2.5% above and below a central rate against the Euro. The Hungarian central bank must give permission for overseas portfolio investments on a case by case basis.*

*The Russian rouble is in a managed floating system but there is a 1% tax on purchases of hard currency. In contrast, the Argentinean peso is pegged to the US dollar at parity ($1 = 1 peso) but international trade transactions (involving current and capital flows) are not subject to stringent government or central bank control.*