Topic 23: Exchange rates

Exchange rate: is the value of one currency expressed as another currency

Fixed exchange rate: exchange rate regime where the value of one currency is fixed or pegged to another currency, or gold.

- Revaluation: raising the value of fixed currency
- Devaluation: lowering the value of fixed currency
- In order to fix the exchange rate from the free market, the government will either buy or sell its own currency to shift demand and supply of its own currency.
- ✓ Reduces uncertainty and allows business to plan ahead
- ✓ Forces governments to keep inflation low because it holds serious threat to the demand for exports and imports
- \- manipulation of interest rates may increase the demand for the currency at the expense of lowering demand and increasing unemployment
- \- Government has to maintain high levels of foreign reserves
- \- Finding a suitable exchange rate is difficult
- \- A country that fixes their exchange rate at an artificially low level may create international disagreement

Floating exchange rate: an exchange rate regime where the value of a currency is determined by the demand and supply of the currency in the foreign exchange market

- Appreciation: increase in value of a currency against another
- Depreciation: decrease in value of a currency against another
- Factors that affect the value of currency: I4ST – inflation, interest, income investment, speculation, taste
- ✓ Interest rates are free to be employed as domestic monetary tools and used for demand management policies to control inflation
- ✓ Auto-correction to keep the current account balanced
- ✓ No need to keep high levels of reserves
- \- Uncertainty on international markets
- \- Floating exchange are affected by government intervention
- \- May worsen existing levels of inflation

Managed exchange rates: the central bank will set an upper and lower limit for the exchange rate to float and if the exchange rates exceed the band, the central bank will intervene in the forex.

High exchange rate

- Imports are cheaper – more consumer choice, cheaper to import raw materials, may harm smaller domestic industries because they face more competition
- Exports are more expensive – making it less competitive, force export industries to be more efficient
- Downward pressure on inflation

Low exchange rate

- Imports are more expensive – raw material and finished goods are more expensive
    - Puts pressure on inflation
- Exports are cheaper – causes employment in the export industry