What is an Exchange Rate?

- The price of a nation's currency in terms of another currency.
- An exchange rate thus has two components, the domestic currency and a foreign currency.

Types of Exchange Rates

We will be exploring three types of Exchange Rates which are:

1. Fixed Exchange Rate
2. Floating/Flexible Exchange Rate
3. Managed Float

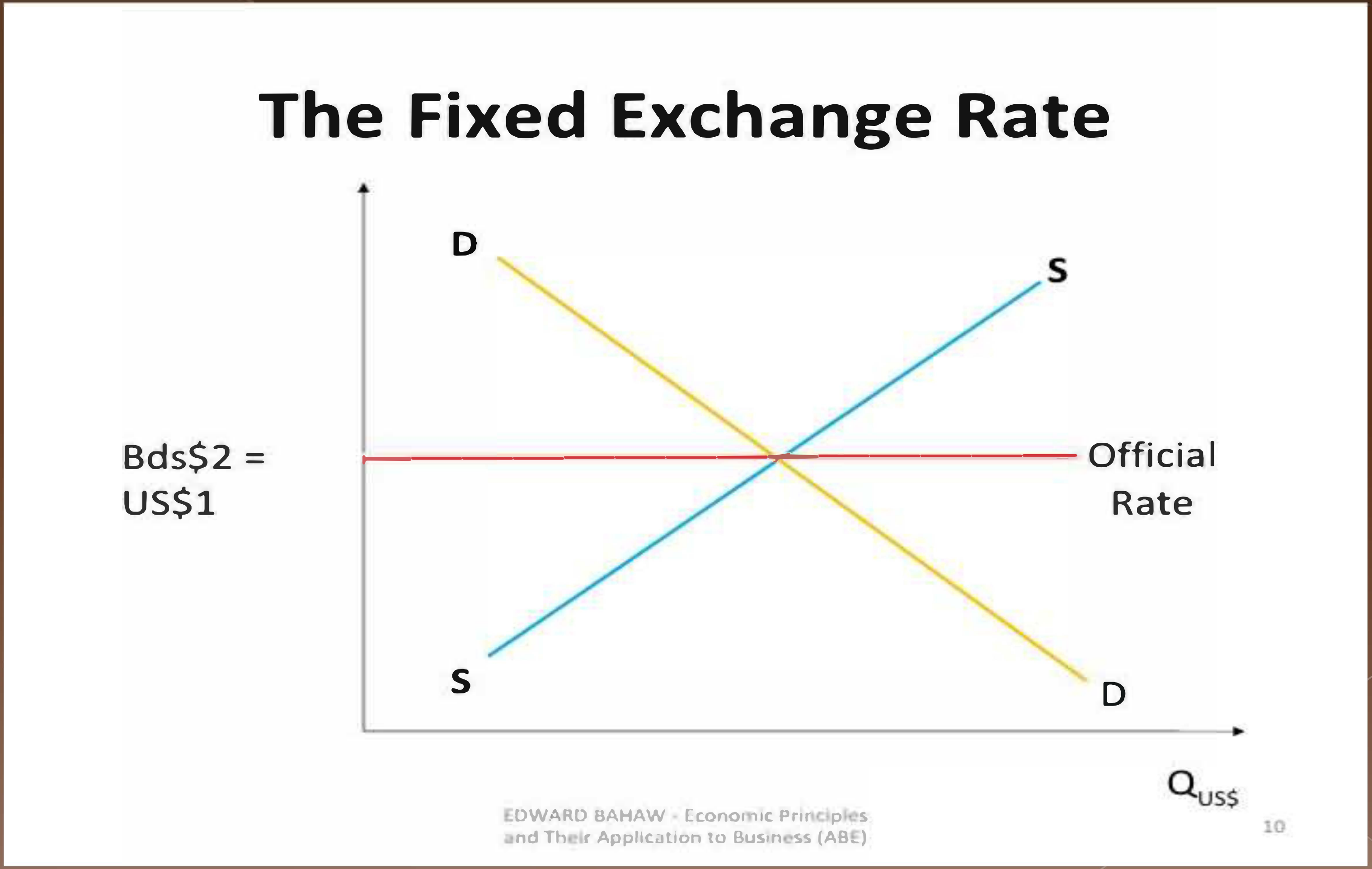
Fixed Exchange Rate

- This is where a Government maintains a given exchange rate over a period of time.
- This could be for a few months or even years.
- In order to maintain the exchange rate at the stated level government uses fiscal and monetary policies to control aggregate demand.

Determination of Fixed Exchange Rate

- In a fixed exchange rate system the XR is set by the government or central bank at a particular rate.
- The forces of supply and demand do not determine the rate. The central bank holds reserves of US dollars and intervenes in order to keep the exchange rate pegged at that level known as the Official Rate.

Representation of Fixed Exchange Rate



Floating/Flexible Exchange Rate

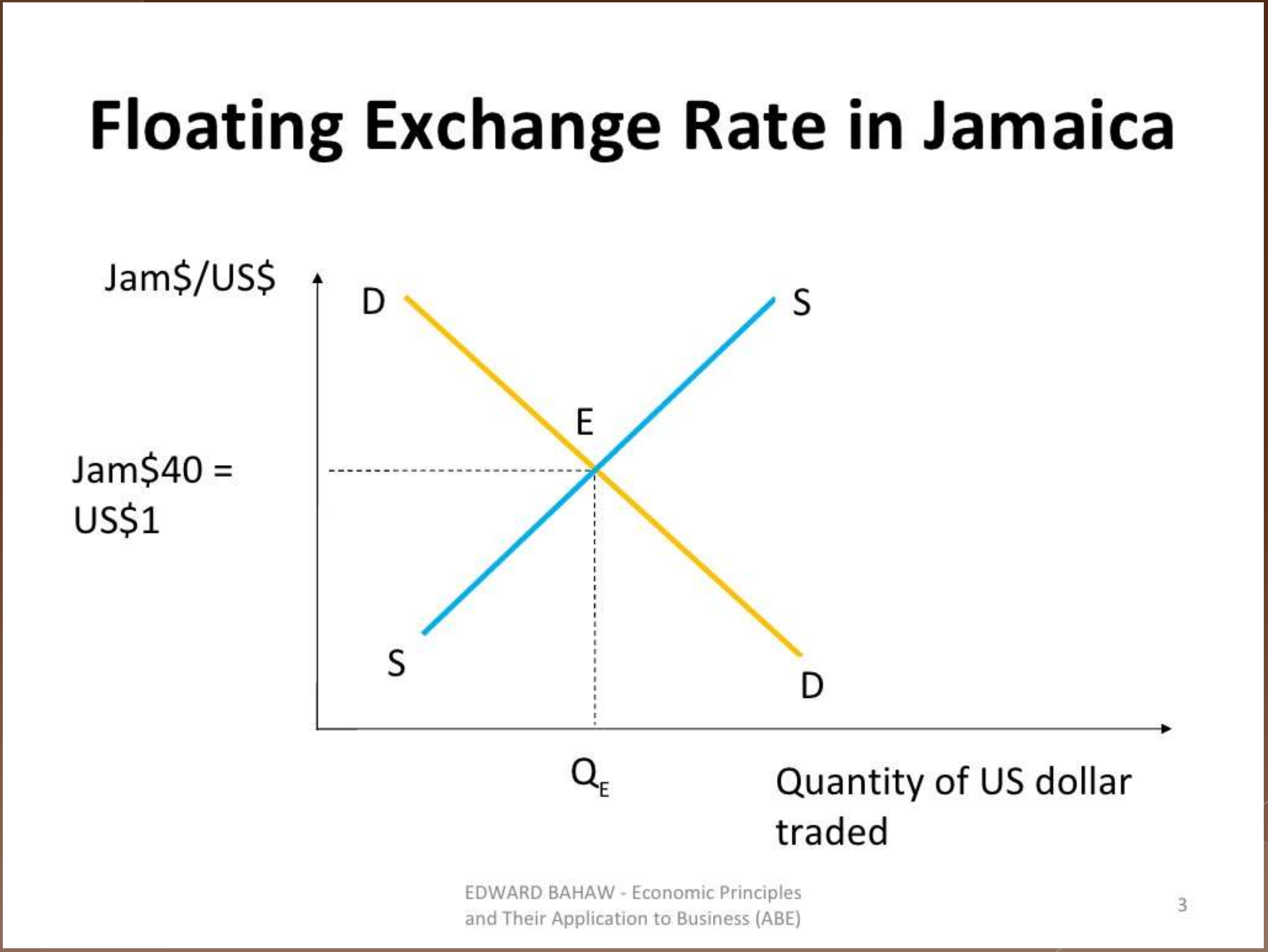
- A floating exchange rate regime is where the rate of exchange is determined purely by the demand and supply of that currency on the foreign exchange market.

Determination of Floating Exchange Rate

- The value of a currency is allowed to be determined by the forces of demand and supply on the foreign exchange market.
- There is no government intervention.

- Any change in supply or demand for a currency will cause a depreciation or appreciation in the exchange rate.
- An increase in demand for the local currency causes it to appreciate or rise.
- However, if there is a greater demand for the foreign currency the value of the local currency falls or depreciates to the foreign currency.

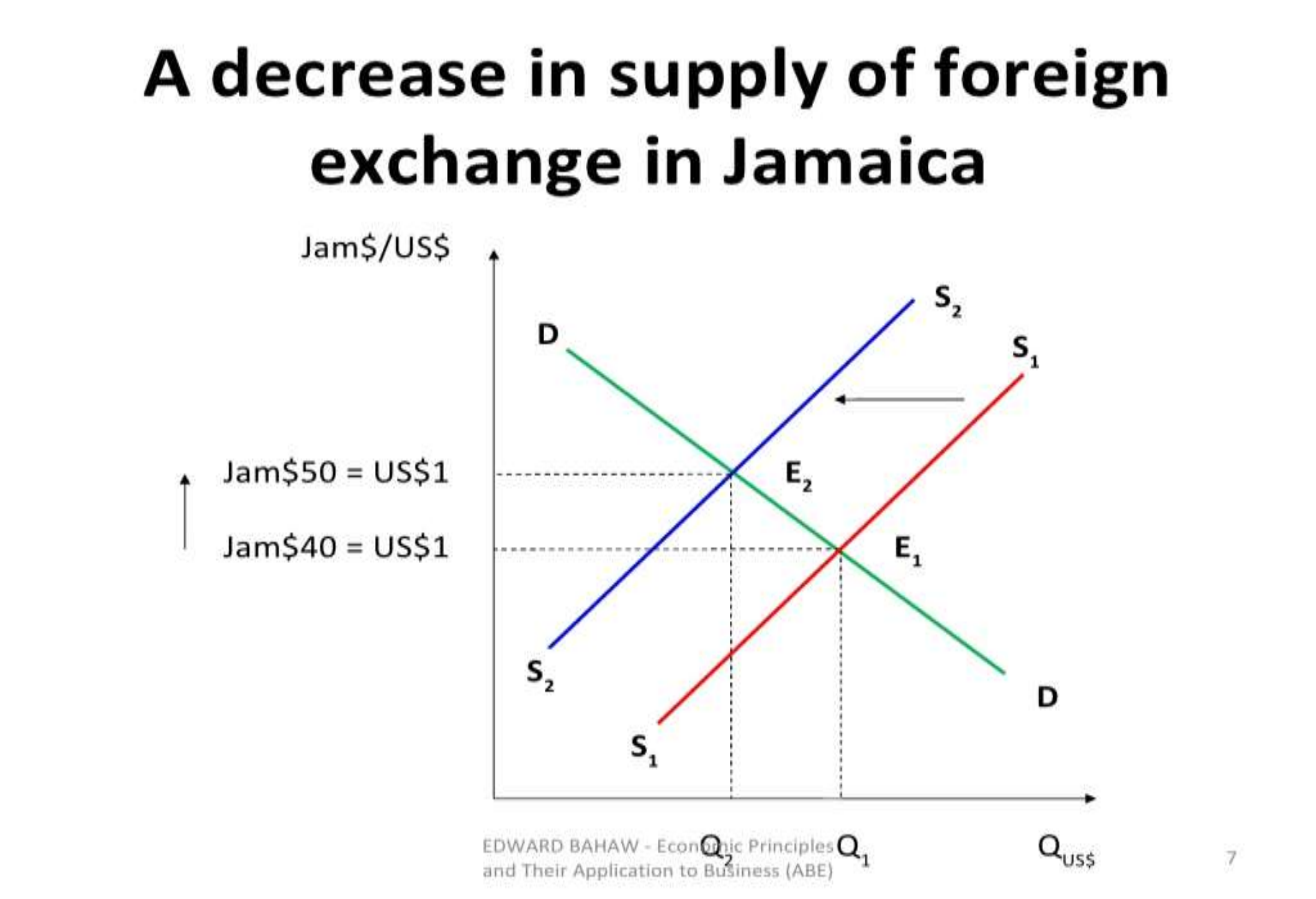
Representation of Floating Exchange Rate



Currency Appreciation

- An appreciation means an increase in the value of a currency. It means a currency is worth more in terms of foreign currency.
- A rise or appreciation in the economy in the country's currency will mean that the price of imports into the country will fall and the price of the country's exports will rise.
- This is represented by a shift in the supply curve to the left.

Representation of Currency Appreciation

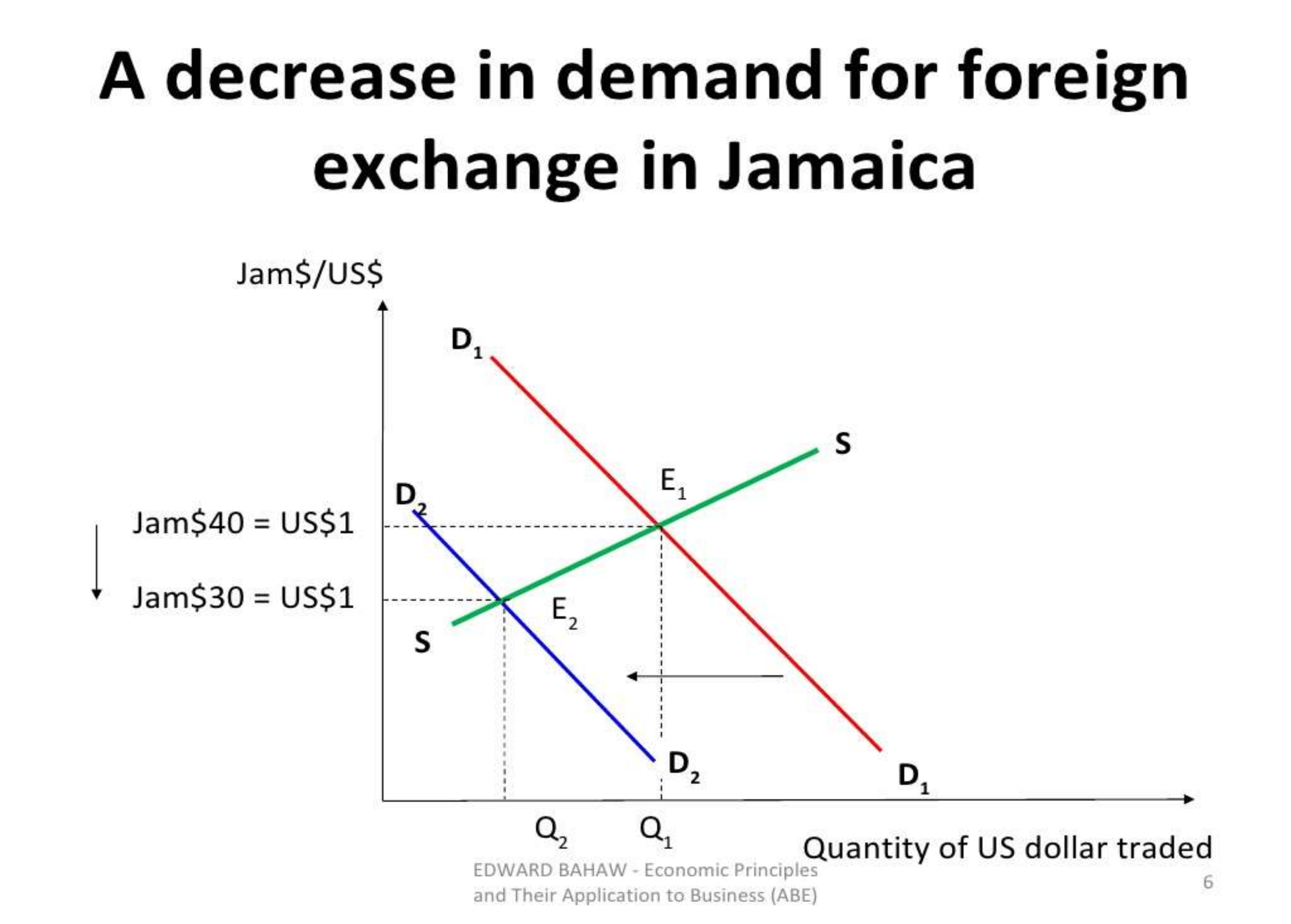


Do not Pay attention to the current xrate as this was way back in 1999 and just an example

Currency Depreciation

- A depreciation means a decrease in the value of a currency. It means a currency is worth less in terms of a foreign currency.
- A fall or depreciation in the value of the exchange rate will mean the opposite, that is the price of imports into the country will rise and the price of the country's export will fall.
- This is represented by a shift of the demand curve to the left.

Representation of Currency Depreciation



Managed Float Exchanged Rate

- This is where the currency is broadly managed by the forces of demand and supply but the government takes action to influence the rate of change in the exchange rate.

Determination of Managed Float Exchange Rate

- The Central Bank seeks to stabilize the exchange rate within a predetermined range for a given period of time, but **DOES NOT FIX IT** at any particular level. This allows for policy makers the benefit of planning with some degree of certainty, for the macroeconomic affairs of a country.
- Central bank intervenes to smoothen out ups and downs in the exchange rate of home currency to its own advantage.

Representation of Managed Float