IMPACT OF CHANGING EXCHANGE RATES

Appreciation & Revaluation

- Appreciation of a currency is where the value of a currency rises owing to market forces - the exchange rate increases as a result. This means that the nation's currency is stronger, it has appreciated and now a unit of one currency can buy more of another currency. An example of appreciation would be if 1 TRY = £0.14 and afterwards 1 TRY becomes £0.20.
- In a minority of countries (such as Bulgaria, Denmark and Egypt), the exchange rate is fixed. This means that it does not vary and stays the same all of the time.
- Revaluation of a currency is when a government fixes a higher exchange rate to reflect current valuations. If a government raises the exchange rate so that it is stronger, the currency is said to have been revalued.

Depreciation & Devaluation

- Depreciation of a currency is where the value of a currency falls owing to market forces - the exchange rate falls as a result. This means that the nation's currency is weaker, it has depreciated and now a unit of one currency can buy less of another currency. An example would be if before 1 TRY = £0.14, and afterwards 1 TRY = £0.10.
- Devaluation of a currency is when a government fixes a new lower exchange rate to reflect current valuations. If this happens, the exchange rate will fall and the currency will be devalued.

Impact of Exchange Rate Appreciation

In the following scenarios assume that the exchange rate rises from £1 = US$1.50 to £1 = US$2.

Impact on Exports

If a UK firm sells goods worth £2 million to a US customer, the dollar price at the original exchange rate is US$3 million (£2 million × US$1.50). When the exchange rises, the dollar price of the goods also rises to US$4 million (£2 million × US$2). This means that demand for UK exports is likely to fall because they are now more expensive.

Impact on Imports

If another UK firm buys goods worth US$600 000 from a US supplier, the price in pounds at the original exchange rate is £400 000 (US$600 000 × US$1.50). When the exchange rate rises, the sterling price of the importer falls to £300 000 (US$600 000 × US$2). This means that demand for imports is likely to rise because they are cheaper.

Impact on the Current Account

When the exchange rate appreciates, the impact on the current account is likely to be negative. This is because demand for exports is likely to fall (because they are more expensive) and the demand for imports is likely to rise (because they are cheaper). This could result in a current account deficit worsening or the current account surplus decreasing.

Impact of Exchange Rate Depreciation

Impact on Exports

Demand for exports is likely to rise because they are now cheaper (firms more competitive abroad).

Impact on Imports

Demand for imports is likely to fall because they are more expensive.

Impact on the Current Account

When the exchange rate depreciates, the impact on the current account is likely to be positive. This is because demand for exports is likely to rise (because they are cheaper) and the demand for imports is likely to fall (because they are more expensive). This could result in the current account deficit falling or the current account surplus increasing.

<u>Exchange Rate & Government Policy</u>

Over a period of time, a country must pay its way when trading with others. A government should therefore aim to balance the current account. If there is a large and persistent current account deficit, a government can let the currency depreciate. If the exchange rate falls, the price of exports falls and the price of imports rises. Therefore, a deficit on the current account should be reduced because demand for exports would rise and the demand for imports would fall. A government can help a currency to depreciate by changing interest rates in the economy. However, there are some problems with this policy.

- The government might not have complete control over the interest rate. E.g. in the UK, the Monetary Policy Committee of the Bank of England sets the interest rate.
- Reducing interest rates to devalue a currency may conflict with other policies. E.g. reducing interest rates when a government is also trying to control inflation is likely to cause more inflation.
- Devaluation will only work if the demand for exports and imports is responsive to price changes.

<u>Exchange Rate Changes & Price Elasticity</u>

- The effectiveness of government exchange rate policy will depend on the price elasticity of demand for imports and exports. E.g. if interest rates in the UK are reduced and the value of the pound falls, a current account balance deficit will only be reduced if the demand for imports and the demand for exports are both elastic. If demand were price inelastic, a fall in the price of exports, for example, would have very little effect on the demand and therefore, a current balance deficit would not be significantly reduced.
- A country that imports mainly primary goods, such as essential foodstuffs, fuel and minerals, may find it difficult to reduce demand. This is because demand for such goods is likely to be price inelastic and higher prices resulting from a depreciation are not likely to reduce demand significantly. A country that wants to boosts exports will be more successful if demand for those exports is price elastic. A depreciation in this case might work if exports are non-essentials such as tourism or consumer durables.