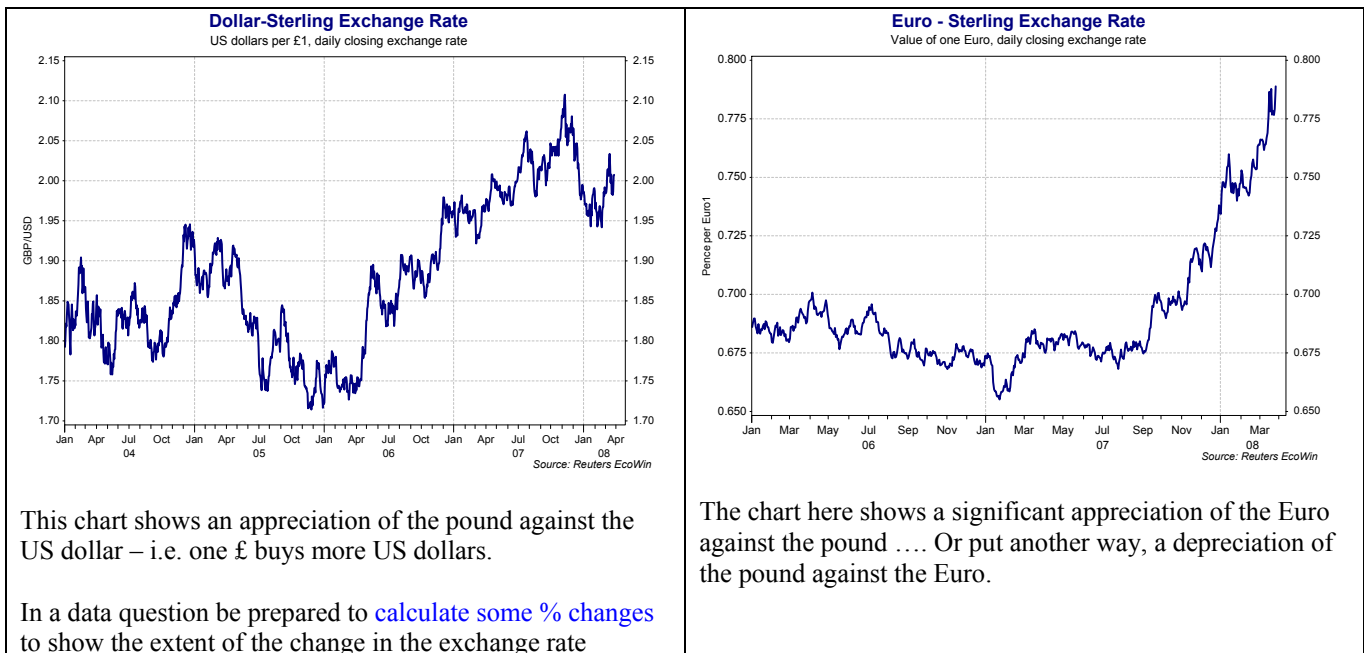


Revision Focus – Exchange Rates (AS Economics)



In March 2008, the value of the pound against the Euro has fallen to a five year low whilst at the same time sterling is strong against the US dollar. What causes these changes in exchange rates and how is the economy affected by movements in the external value of a currency?

Definition:

The exchange rate measures the **purchasing power** of a currency in terms of what it can buy of other currencies

Demand and supply for a currency

Currency flows from one country to another are the result of

- (1) **International trade flows** in goods and services (exports – an injection, imports – a leakage)
- (2) **Capital flows** (e.g. net flows of foreign direct investment and speculative flows of money between countries into banks etc) – interest rate differentials between countries can make a difference – for example, expectations that the Bank of England will cut interest rates in the second half of 2008 has been [one factor causing a fall in demand for sterling](#) in the foreign exchange markets.
- (3) A large share of trading is **purely speculative** – i.e. currency dealers seeking to make a profit! E.g. you might buy Euro's in the expectation that the dollar will fall against the Euro

Floating exchange rates

The UK operates with a **floating exchange rate system** - this means that our currency is **market determined**

- If the demand for sterling rises relative to supply, then the external value of the pound will **appreciate**
- If the supply of pounds on the foreign exchange market increases relative to demand, then the pound will **depreciate** in value

Changes in the exchange rate and macroeconomic effects

At AS level, the key is to be able to explain and also evaluate some of the macroeconomic effects of movements in the exchange rate. For revision - changes in the exchange rate affect variables such as:

- The prices of / demand for imported goods and services
- The prices of / demand for exported goods and services
- Aggregate demand (e.g. $C+I+G+X-M$)
- The growth of real national output in the short term
- The profitability / competitiveness of exporters
- The rate of cost and consumer price inflation
- Employment / unemployment in “traded goods” industries i.e. exporting businesses and firms facing import competition from overseas

The exchange rate and inflation

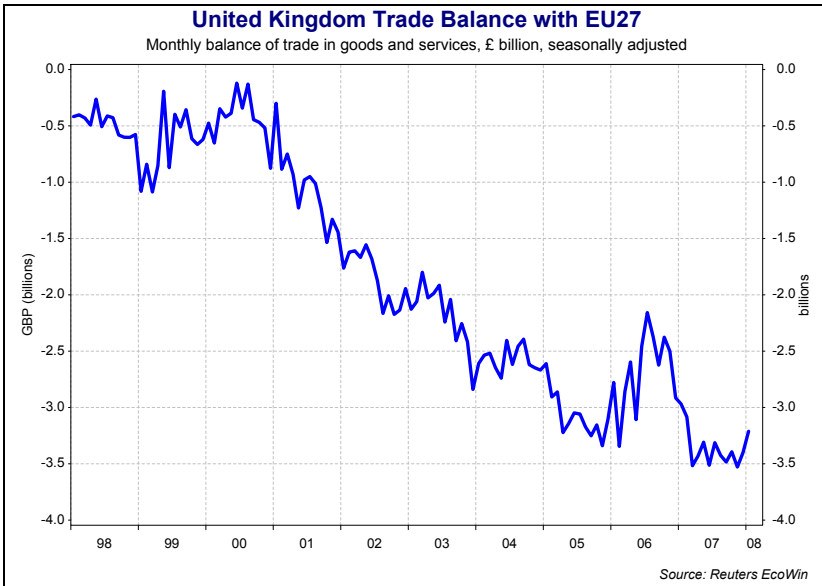
- (1) A weaker pound drives up import prices - higher import prices drive up firms’ costs
- (2) Higher import prices feed directly into the consumer price index - E.g. prices of imported computers, cars, household furniture and food & beverages
- (3) Second round effects can be important - E.g. higher import costs might cause an increase in wage claims as people look to protect their real incomes
- (4) Weaker pound also leads to stronger AD E.g. faster growth of exports and a slower growth of imports - Stronger aggregate demand can increase inflationary pressure – depending on the amount of spare capacity in the economy (elasticity of supply)

The rising Euro and the UK economy – advantages and disadvantages for the UK

The rising euro is good news for British exporters but is squeezing those who import European goods

Benefits of the rising Euro	Costs of the rising Euro
Makes UK exports more competitive	Increases the costs for firms importing products from Euro Zone countries – lowers their profit margins
Should boost the value of UK exports and create more jobs – positive multiplier effect	Over 60% of our trade is with Europe – a falling pound could cause rising inflation – eating into real incomes
Makes the UK more attractive as a venue for foreign investment and re-exporting into the EU	Risk perhaps of demand-pull inflation if the UK economy does not have sufficient capacity
UK runs a trade deficit with the EU – this will help to reduce the size of the deficit	Higher food prices for UK consumers – perhaps hitting lower income families hardest
Rising AD	Fall in SRAS

Remember that changes in the exchange rate take time to feed through into aggregate demand, output, jobs and incomes – there are **time lags**. And much depends on whether the supply-side of the economy has enough capacity e.g. can export industries respond to the competitive boost and increase the volume of exports?



This chart shows the monthly trade balance with fellow member nations of the EU – there has been a significant increase in the trade gap – reaching over £3.5bn per month at the end of 2007.

Perhaps the depreciation in the value of sterling will help to correct some of this ‘trade imbalance’?

But a fall in the exchange rate will not be enough on its own to turn a trade deficit into a surplus!

