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LESSON NOTES

Term 3: Worksheet 2

Subject: Economics Year / Level: 13 Name: ______________________

Strand	4 – International Economics
Sub Strand	The mechanics of exchange rate
Content Learning Outcome	Explore the impacts of changes in exchange rate on balance of payments. Define and analyse the changes in fixed exchange rates. Define difference between revaluation and devaluation.

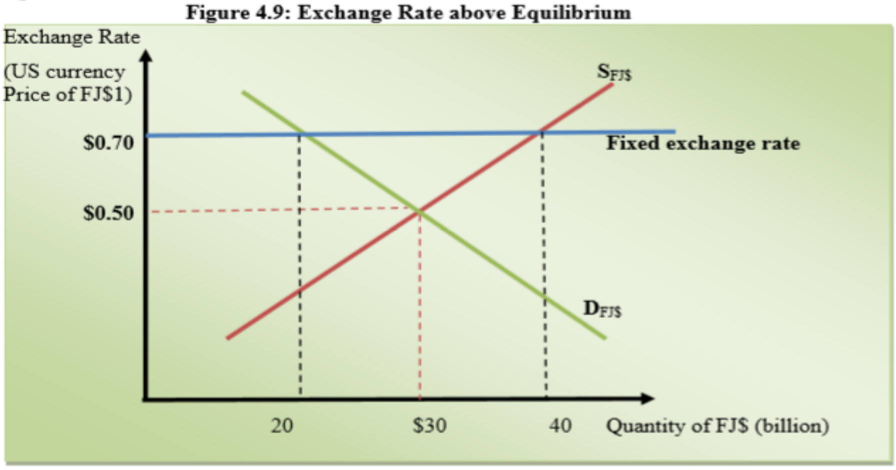
FIXED EXCHANGE RATE

Fixed Exchange Rate system is when the value of a nation's currency is officially set and maintained at some particular level by the government or one of its agencies such as Central Bank. In Fiji for instance Reserve Bank of Fiji determines the exchange rate.

In the graph given below the free market equilibrium exchange rate is FJ$1.00= US$0.50. The equilibrium exchange rate of FJ$30 billion dollars.

Now consider what happens if the government decides to fix the exchange rate above the equilibrium rate.

Figure 4.9: Exchange Rate above Equilibrium



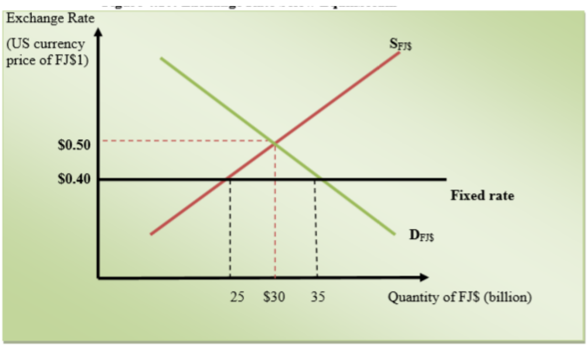
Maintaining a Fixed Exchange Rate

When the government fixes the exchange rate above free market equilibrium at FJ$1.00 = US$0.70, supply of Fijian dollar exceeds the demand for Fijian dollar creating a surplus of $F20 billion.

To maintain the fixed exchange rate FJ$1.00=US$0.70, the Central bank must enter the market and buy $F20 billio

When the government decides to fix the exchange rate below the equilibrium rate

Figure 4.10: Exchange Rate below Equilibrium



When the government fixes exchange rate below the equilibrium at $1.00=US0.40. At this exchange rate demand for Fiji dollar is greater than supply of Fiji dollar creating a shortage of FJ$10 billion.

To maintain the fixed exchange rate the government must enter the market and sell FJ$10 billion worth of Fijian currency.

So in order to maintain a fixed exchange rate, the government or the central bank, must intervene in the free market. It acts as a buyer or seller to ensure, that free market exchange rate coincides with its fixed exchange rate.

Advantages of Fixed Exchange Rate

1. It **promotes stability** i.e. by decreasing risk and uncertainties.
2. Fixed exchange rate **encourages growth of international trade and finance**.
3. It eliminates disruptions caused by both short term variations in the exchange rate and speculation.
4. Stable exchange rate and removable of uncertainty can make long term economic planning easier. 5. **Increases investment, employment and economic growth** because it reassures the risk involved as the overseas investors know that they will receive the scarce profits.

Disadvantages

1 Fixed exchange rate affects the level of international reserves. When fixed exchange rate is above the world market price, government has to sell international reserves (and buy its currency). The international reserves will fall. If the international reserves falls to an unsatisfactory level, then the governments will have to protect them by decreasing demand for imports and capital inflow and vice versa.

2 Fixed exchange rate system usually mean disequilibrium in the balance of payment. A BOP surplus means that the flow of funds into domestic country from exports receipts and capital inflow exceeds the flow of fund out of domestic country to pay for imported goods and capital outflow. While a BOP deficit means that the outflow of funds from domestic country exceeds the inflow of fund into domestic country.

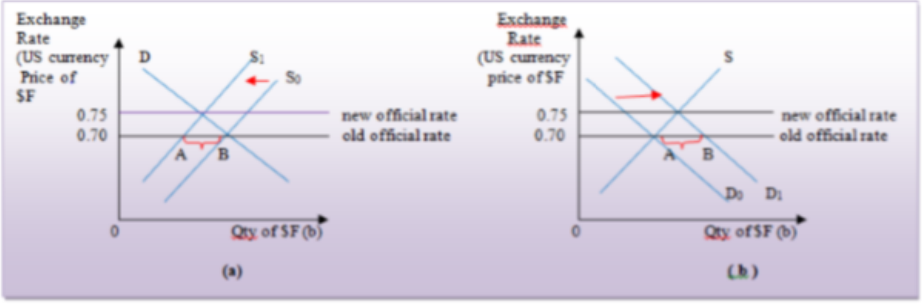
3 Fixed exchange rate influences the level of money supply simply because it creates B.O.P disequilibrium. A BOP surplus means increase in the supply of foreign currency held by domestic commercial banks. The RBF buys these foreign currency and sells the FJ$ to the commercial banks increase in deposits increase in MS. A BOP deficit means decrease in the supply of foreign currency held by domestic commercial banks. The RBF sell these foreign currency and buy the FJ$ from the commercial banks decrease in deposits decrease in MS.

REVALUATION AND DEVALUATION

Revaluation-refers to an increase in the value of the nation's currency i.e. the result of deliberate action by the countries government or central bank.

Assume that the exchange rate is fixed at the initial equilibrium exchange rate of $F1.00 = US$0.70. The decrease in supply of FJ$ from S0 to S1 and an increase in demand for FJ$ from D0 to D1 results in excess demand for FJ$ or a shortage of FJ$.

Figure 4.11



In a short run a decrease in the supply of the Fijian dollar from S0 to S1 in graph (a) results in excess demand of Fijian dollars on the foreign exchange market AB. AB also occurs as initial equilibrium rate following an increase in demand for Fijian dollar from D0 to D1 in graph (b). The Reserve Bank can compensate in the short run by selling Fijian dollar AB.

In the long run however, the official value of the Fiji dollar may need to be increased to say FJ$1.00 = US$0.75 resulting in currency revaluation.

Such a revaluation is likely if the supply of the Fijian dollar continues to fall or demand for them continues to rise. In this event the Fiji dollar have said to have been undervalued at FJ$1.00 = US$0.70.

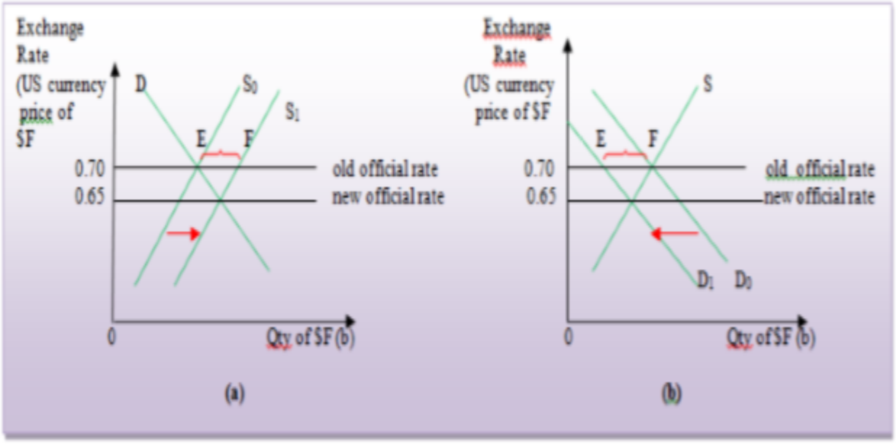
Implications of Currency Revaluation

1. Effectively increases the amount foreign currency which FJ$1.00 will buy.
2. The price of imported goods fall thereby making imports cheaper.
3. Our exports become more expensive
4. Foreign investment becomes cheaper leading to greater capital outflow.
5. Local or domestic firm become less competitive therefore demand for export decreases.

Devaluation

This refers to decrease in the value of a nation's currency that is a result of deliberate action taken by the countries government or its central bank.

Figure 4.12



The graphs show excess supply equal EF at the initial equilibrium exchange rate, when the demand for Fiji dollar on the foreign exchange market decreases from D0 to D1. The reserve bank can compensate in the short run by buying Fijian dollars equal EF.

In the long run however, the authorities may be forced to decrease the exchange rate to say FJ$1.00 = US$0.65 causing currency devaluation. This devaluation will occur if the supply of Fiji dollar continues to rise in the foreign exchange market or if the demand for them continues to fall.

A Devaluation of the Fiji Dollar Has the Following Implications:

i. Decreases the amount of foreign currency which FJ$1.00 can buy.
ii. Increases the price of imported goods, thereby reducing the domestic demand for them.
iii. Decreases the price of exported goods, causing a rise in the demand for domestic goods overseas.
iv. Inflow of capital occurs.
v. Domestic goods become more competitive on the international market.

<u>Activity - 6 marks each</u>

1. Where the government constantly intervenes into the Forex market, buying and selling its currency, then country's exchange rate is said to be

A. floating. B. fixed.
C. pegged to the dollar. D. pegged to the gold standard.

2. If a country has artificially pegged its exchange rate so that it is below the equilibrium, the likely effects will include

   A. a high demand for the over-valued currency on the world market.
   B. imports that are dearer than they should be and export receipts that are increased.
   C. some other way of rationing scarce overseas funds will have to be used in addition to the ruling exchange rate.
   D. the country will find it relatively easy to raise loans on overseas money markets at relatively low rates of interest.

3. The pegged exchange rate is the

   A. price of currencies in terms of each other as determined in the FOREX market.

B. rate that is established by demand and supply of any given economy.
C. rate which can be varied at the discretion of a country's monetary authority.
D. rate expresses in terms of a key currency or basket of currencies.

4. If the Fiji dollar loses value against the overseas currency, which of the following is taken by other countries to be a benchmark?
A. It will cost Fijians more to travel overseas.
B. Fiji exporters will receive more for their output.
C. Less overseas investment will take place in Fiji.
D. Foreign tourists will find it more expensive to stay in Fiji.

5. A devaluation of Fiji dollar
A. leads to the more outflow of capital.
B. increases the amount of foreign currency which FJ$1.00 can buy.
C. domestic goods becomes less competitive on the international market.
D. increases the price of imported goods, thereby reduces the domestic demand for imported goods.

6. A revaluation of Fiji dollar
A. increases the demand for exports.
B. leads to the greater outflow of capital.
C. decreases the amount of foreign currency which FJ$1.00 can buy.
D. decreases the price of imported goods, thereby making imports cheaper.

SHORT ANSWER QUESTIONS – 1 mark each

(a) Define the term fixed exchange rate? How is fixed exchange rate maintained?

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(b) Define the term revaluation and devaluation.

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(c) State two effects of each; revaluation and devaluation of Fiji dollar.

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(e) What is meant by the term international reserves?

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Essay – 10 marks

A financial crisis will lead to a severe devaluation of a country's currency.

Discuss the above statement with reference to:

- the definition fixed exchange rate, revaluation and devaluation
- any 2 benefits of devaluation of Fiji Dollar to the economy
- any 2 drawbacks of devaluation of Fiji Dollar to the economy

THE END