PENANG SANGAM HIGH SCHOOL
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LESSON NOTES

Subject: Economics   **Year/Level:** 13

Week 23-24

Strand	4	International Economics
Sub Strand	4.1	The mechanics of Exchange Rates
Content Learning Outcome	Explore the impacts of changes in exchange rate on Balance of Payments	

Greetings to all….

We will now move with strand 4…..

Achievement indicators: (Attach in your note book)

1. Define exchange rate and the foreign exchange market
2. Describe and illustrate how foreign exchange market works
3. Differentiate between Revaluation and Devaluation
4. Graphically illustrate Revaluation and Devaluation
5. Convert one currency to another
6. Define foreign reserves and its importance in the exchange market

Lesson Notes

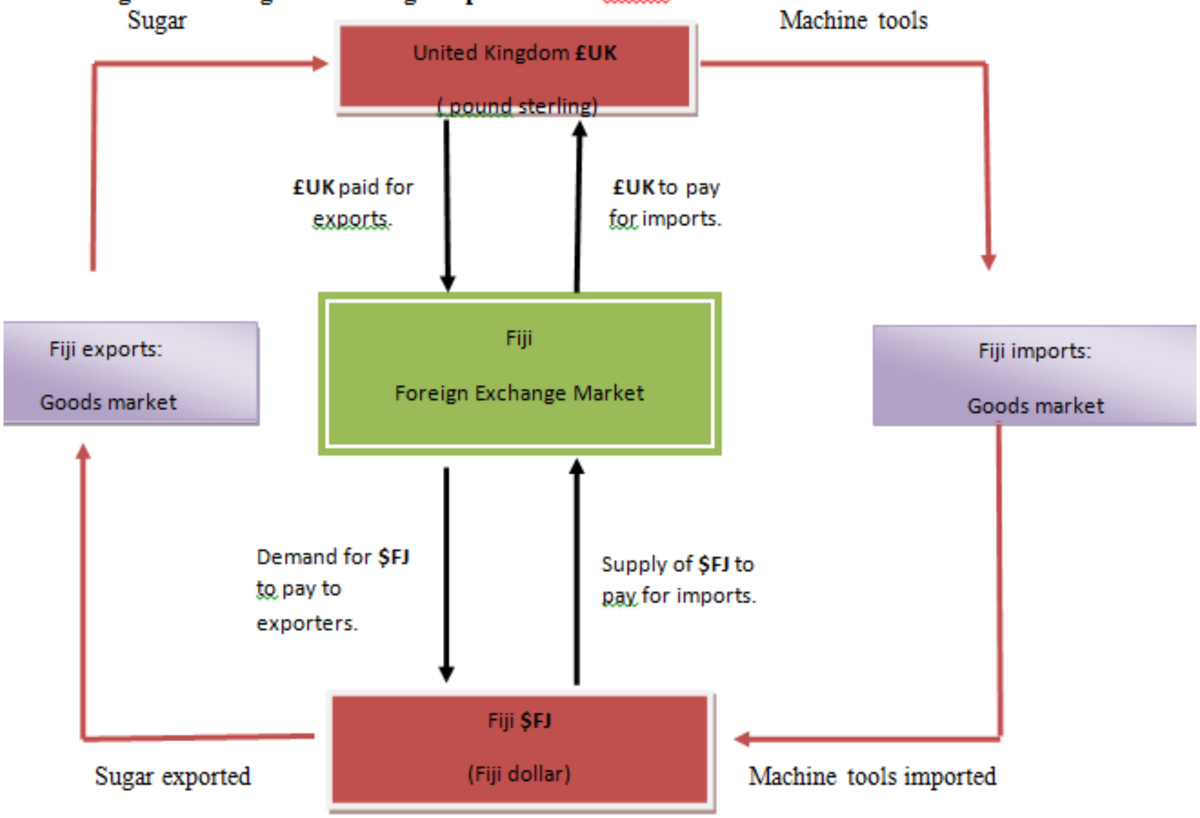
Exchange Rate- Exchange rate is expressed as the foreign currency equivalent of one unit of domestic currency for e.g. FJ$1=US$0.46.

Foreign exchange Market (FOREX Market) - It is a situation in which currency of one country is traded for that of another. The foreign exchange market involves many buyers and sellers. The existence of buyers and sellers implies the operation of the market forces of supply and demand.

Process in Foreign Exchange Market

The process of trading the currency of one country for the currency of another occurs in forex market. This process is necessary for international trade to take place in a world of different currencies. The value of one currency versus another is determined by the international exchange rate and is subject to fluctuations based on open trading of currency

Figure 4.1: Diagram showing the processes of Forex market



Equilibrium in foreign exchange market

The demand for currency

The demand for currencies is derived from the demand for a country's exports, and fromspeculators looking to make a profit on changes in currency values.

The supply of currency

The supply of a currency is determined by the domestic demand for imports from abroad. For example, when the Fiji imports Cars from Japan it must pay in Yen (¥), and to buy Yen it must sell (supply) Fiji dollars.

Exchange rate is determined by the currency requirements of exporters and importers only. The demand for Fiji $ is expressed by those who have overseas currencies in foreign exchange market.The supply of Fiji $ is provided by the importers who wants to buy other currencies.

TYPES OF EXCHANGE RATE REGIMES

There are two types of foreign exchange rate systems:

1. **Floating Exchange Rate**

This rate is determined by interaction of forces of supply and demand for currency. The ratemoves freely in response to competitive market forces. This system is also referred to as **flexible exchange rate.**

2. **Fixed Exchange Rate**

Exchange rate is determined by the government or a central bank. It can be fixed against thevalue of gold or pegged against the value of another currency such as US dollar.

Clean float versus dirty float

Clean float / Pure Exchange Rate

Occurs when the value of a currency, theexchange rate, is determined purely by supply and demand.

Dirty float/ Managed Float

Floating currency exchange rate system which is not controlled entirely by the market forcesof demand and supply. Instead, it is at least partially controlled by government intervention that limits appreciation or depreciation of the currency within a range.

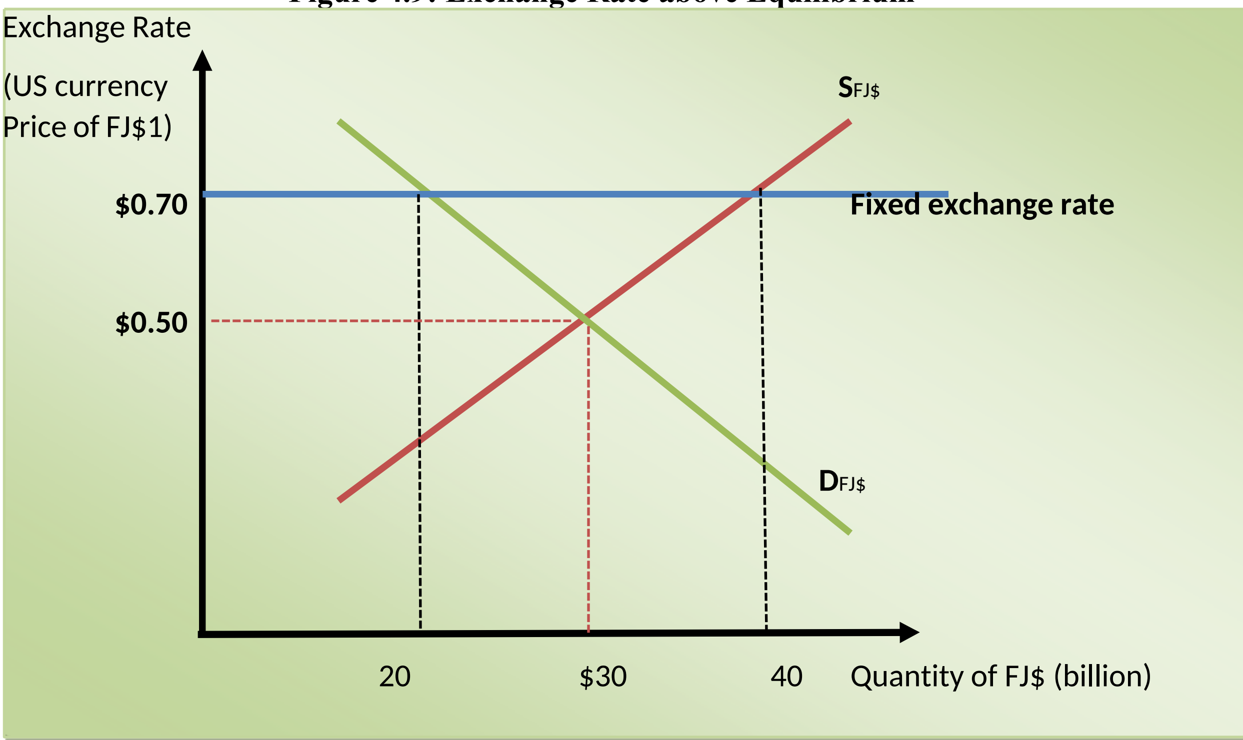
FIXED EXCHANGE RATE

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 theequilibrium rate.

Figure 4.9: Exchange Rate above Equilibrium

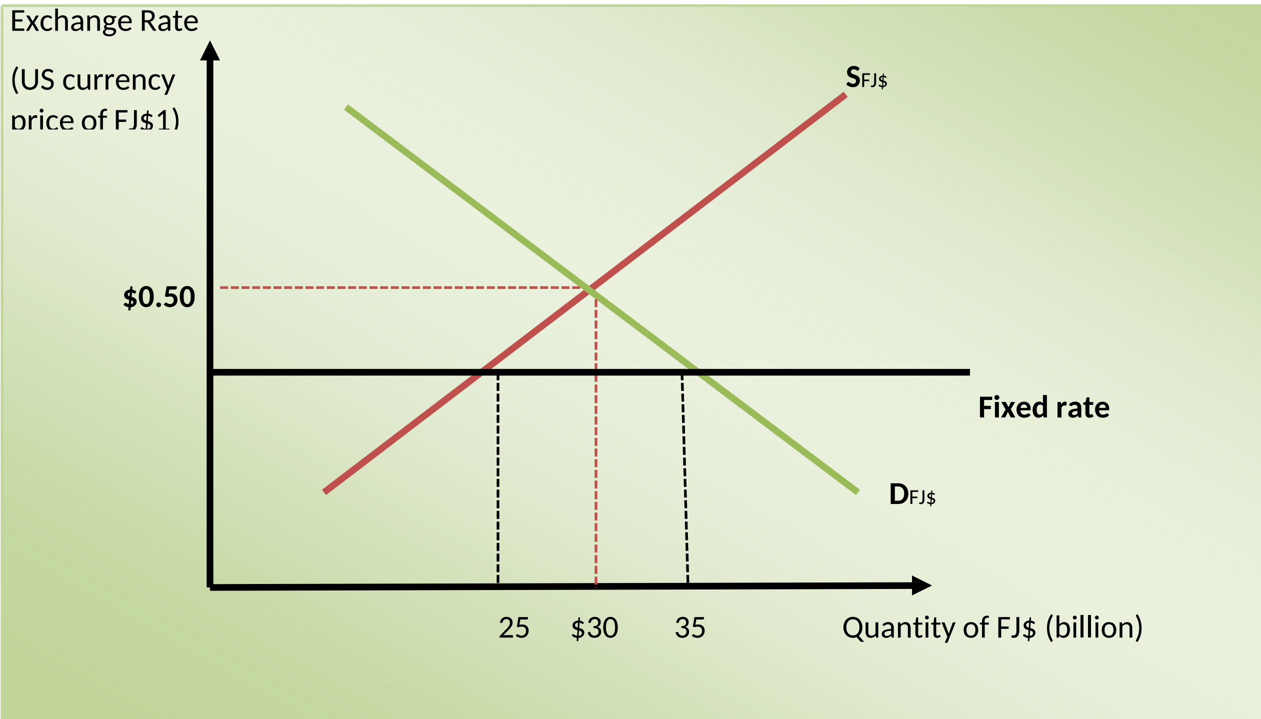


Maintaining a Fixed Exchange Rate

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 $F20billion.

To maintain the fixed exchange rate FJ$1.00=US$0.70, the Central bank must enter the marketand buy $F20 billion.

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. **The level of international reserves**

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. **Balance of payment**

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. **Domestic money supply**

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. →

Read the notes and analyze the graphs…..Stay safe…..