Exchange Rate

IGCSE

Learning Objectives

1. What are exchange rates?
2. Why are exchange rates important?
3. When are exchange rates used?
4. What is free floating exchange rate?
5. What are other types of exchange rates?

What are exchange rates?

Exchange rates refer to value of one currency in terms of another.

Meaning how many Pakistani rupees would be needed to buy $1?

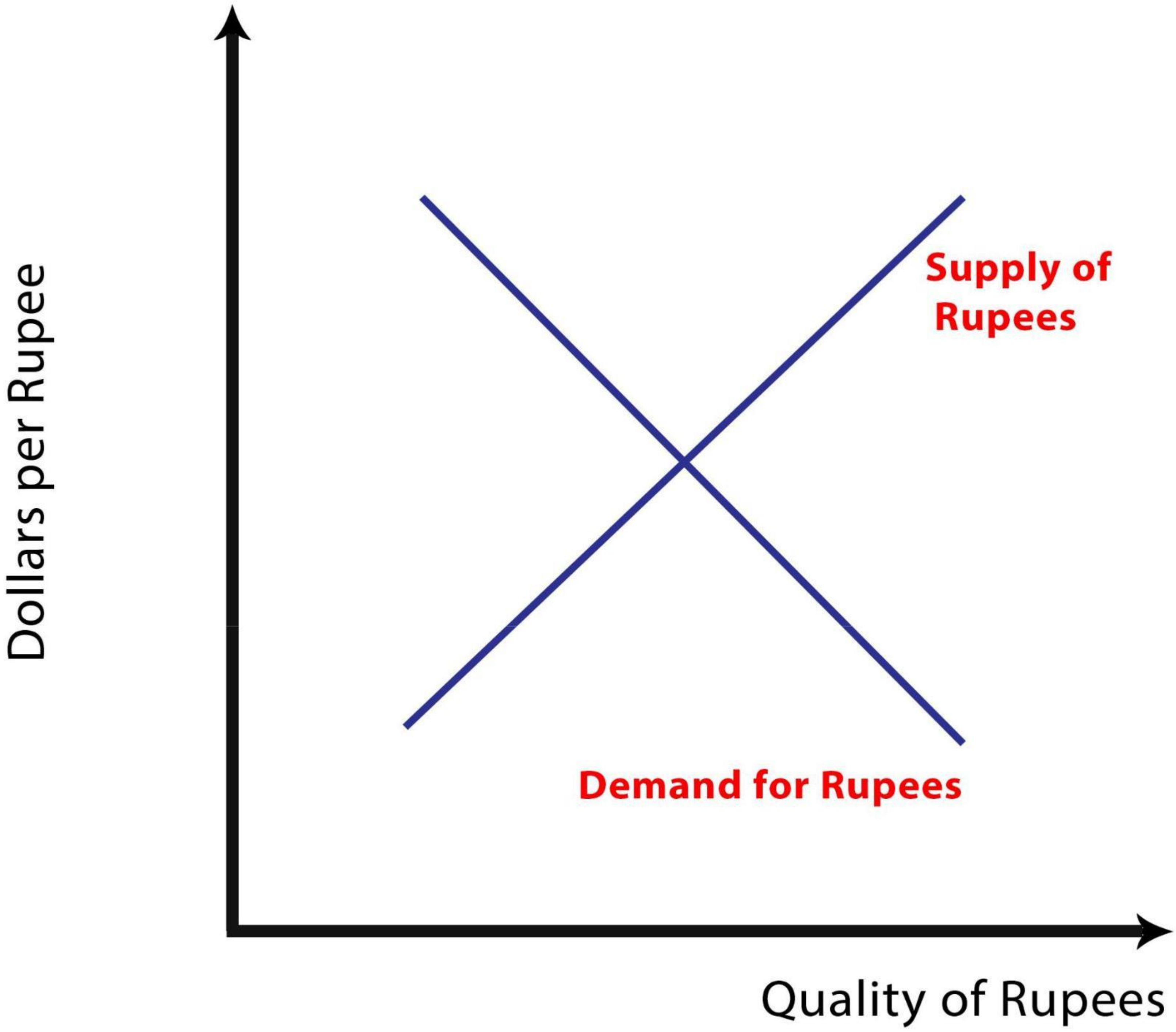
So if we need Rs 160 to buy $1 then exchange rate of Pakistani rupees against dollar would be as follows

$$\$ 1 = Rs\ 160$$

How are exchange rate determined?

Just like normal products the prices of which are determined by the market forces of demand and supply, the currency is also a product the value of which is determined through the market forces of demand and supply of any currency

How are exchange rates determined?



When do we use exchange rates?

When countries or individuals engage in international trade – trade outside your country. For instance

1. when you import from Amazon
2. Pakistani textile manufacturer exporting goods to China etc.

In the first example we are paying in rupees but rupees will be converted to dollars at some future point in time.

In the second example will pay our business in Chinese Yuan which will be converted in rupees at some future point in time.

How the demand and supply of currency changed in each case?

1. When you import from Amazon
2. Pakistani textile manufacturer exporting goods to China etc.

In the first example we are paying in rupees but rupees will be converted to dollars at some future point in time. So supply of rupees will increase and demand for dollars will increase.

In the second example will pay our business in Chinese Yuan which will be converted in rupees at some future point in time. So the demand for rupees will increase and supply of Yuan will increase.

When countries import?

The supply of importing country's

currency will increase which will cause its exchange rate to fall.

When countries export?

The exporting country's currency demand will increase which will cause that country's exchange rate to increase.

When tourism is coming in the country?

The demand of currency of the country in which tourists are coming in will increase.

Types of Exchange Rates

Free Floating: any ER that is naturally maintained due to natural demand and supply of currency. In this type of exchange rate there is no government intervention.

Managed Exchange Rate

Types of Exchange Rates

Fixed Exchange Rate: it is the type of exchange rate that is maintained by the government. When government wants to artificially increase the value of its currency it will start buying the local currency and when they want to decrease the value of currency they will start selling.

Fixed Exchange Rate

Fixed Exchange Rate: it is the type of exchange rate that is maintained by the government. When government wants to artificially increase the value of its currency it will start buying the local currency and when they want to decrease the value of currency they will start selling.

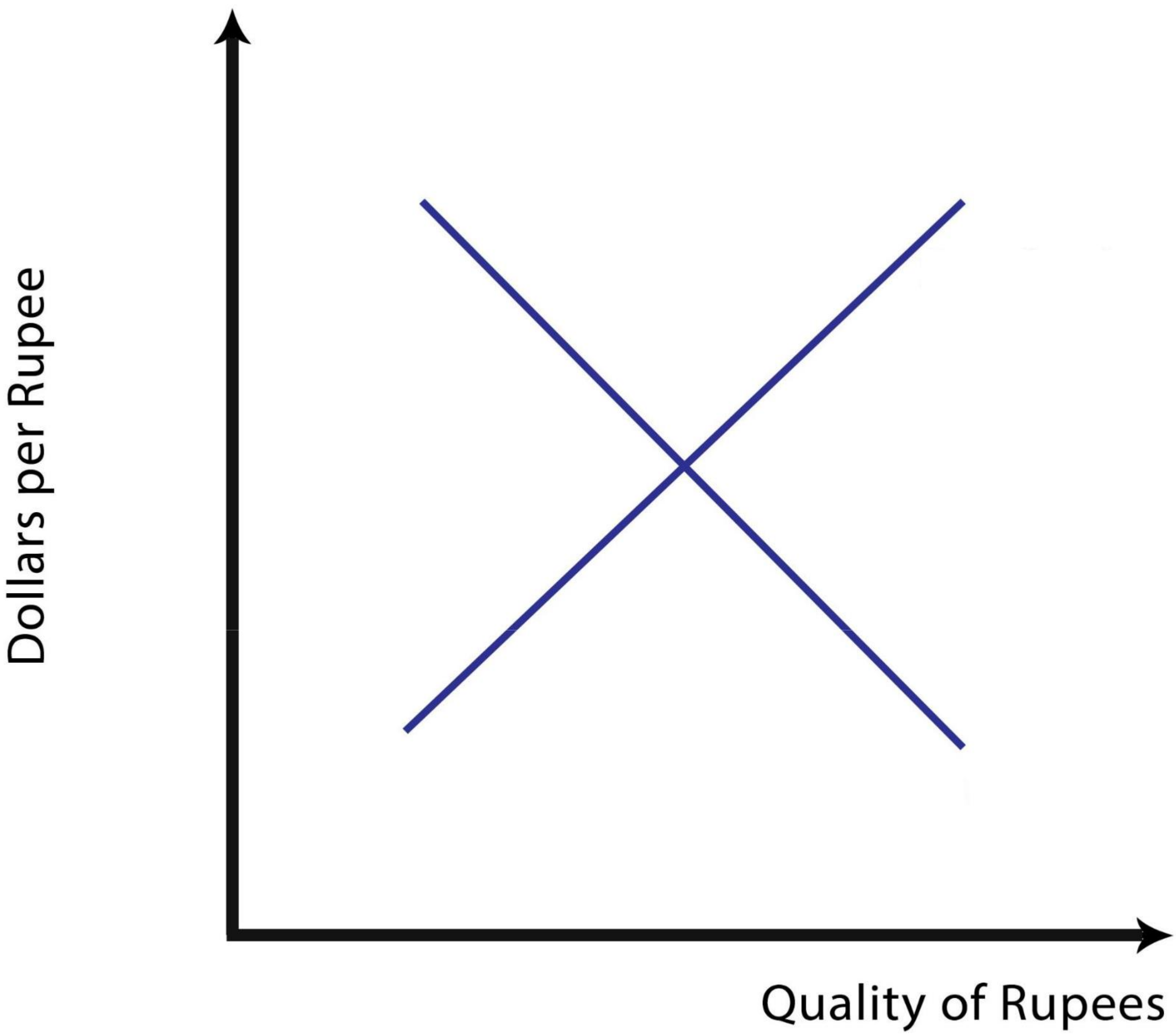
Free Floating Exchange Rate

It is when Exchange Rate is solely determined by the market forces of demand and supply without any government intervention.

Appreciation is when exchange rate is becoming stronger.

Depreciation is when exchange rate is becoming weaker.

Free Floating Exchange Rate



Fixed Exchange Rate

When government artificially increase or decrease the value of exchange rate it is known as Fixed Exchange Rate.

When government artificially increases the value of its exchange rate by selling foreign currency and buying local currency it is known as Revaluation.

Fixed Exchange Rate

On the other hand when government wishes to weaken its exchange rate by selling rupees and buying foreign currency this is known as Devaluation.

Advantages and Disadvantage of Fixed Exchange Rate

The biggest disadvantage of Fixed ER is that the country is using up its precious foreign currency reserves that it could have used for other purposes like paying back foreign debt.

However the advantage of Fixed ER is that it prevents exchange rate from fluctuating.

Managed Exchange Rate

Managed ER is a mixture of the first two types of ER meaning it is a mix of Free Floating and Fixed ER.

It has 2 limits the upper limit and the lower limit.

AS LONG AS THE ER IS WITHIN THE LIMITS THE GOVERNMENT IS NOT CONCERNED BUT WHEN THE ER MOVES OUTSIDE THE LIMITS THEN GOVERNMENT INTERVENES TO CORRECT THE SITUATION.

How Managed ER works

Managed Exchange Rate

When ER moves stronger than the upper limit the central bank will sell your currency to make it artificially weaker and when the ER goes lower than the lower limit then the central bank will buy the currency to make it stronger.

Advantages and Disadvantages of Exchange Rate Appreciation

1. Will make foreign products cheaper in terms of local currency hence the imports are expected to increase.

2. The cost of imported raw material will decrease which will reduce the overall cost of production for the business. Like the cost of importing Oil, machines, and other raw material will become cheap.

Advantages and Disadvantages of Exchange Rate Appreciation

3. Due to higher exchange rate the country's exports will become more expensive and therefore the exports are expected to decrease.

4. Due to lower exports and more imports the country's balance of payments is expected to become worse and that is expected to reduce the foreign currency reserves.

Advantages and Disadvantages of Exchange Rate Depreciation

1. The price of imports will increase which will reduce the demand for imports. Hence the citizens will be left with no option but to but goods locally.
2. Secondly since your products are becoming cheaper for foreign countries the demand for exports will increase.

Advantages and Disadvantages of Exchange Rate Depreciation

3. Hence higher exports and lower imports of the country will result in balance of payments surplus which will resulting higher foreign currency reserves.