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Economics Revision Focus: 2004

AS Economics

Exchange Rates - Introduction

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Revision Focus on Exchange Rates (AS)

AS Syllabus Requirements
Students should also be aware that a fall in the exchange rate will reduce the price of exports, raise import prices and stimulate domestic demand affecting output, employment and the balance of payments on current account.

The exchange rate

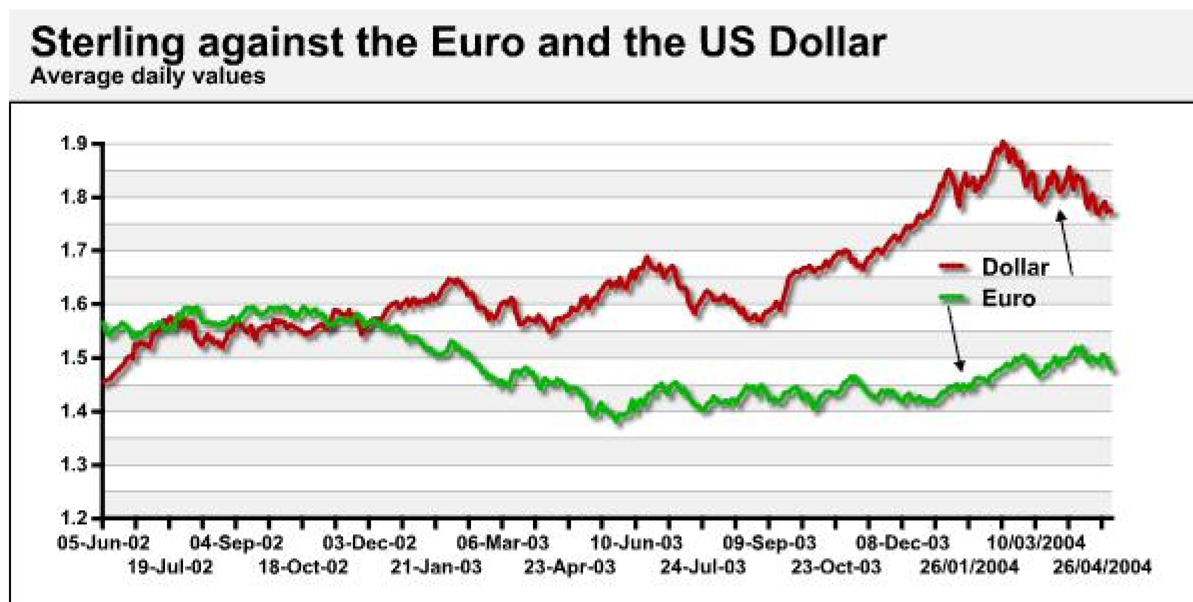
The exchange rate measures the **external value of sterling** in terms of how much of another currency it can buy. For example - how many dollars or Euros you can buy with £5000.

The daily value of the currency is determined in the foreign exchange markets (FOREX) where billions of $s of currencies are traded every hour.

The UK is currently operating with a **floating exchange rate** – where the currency's value is purely market determined and the Bank of England does not seek to intervene through buying and selling currencies in order to influence the pound's value.

In contrast, the member states of the Euro Zone have created a **single currency** eliminating individual national exchange rates against each other – although the **Euro** is free to float against the pound, the US dollar ($) and other currencies.

Recent trends in the exchange rate



1. Since the summer of 2002, the pound has **depreciated** a little against the Euro
2. During the second half of 2003, the pound **appreciated** against the US dollar – but in the first few months of 2004 the dollar has regained some ground – sterling has depreciated back towards £1 = $180

How does a change in the exchange rate influence the performance of the economy?

Changes in the exchange rate can have a powerful effect on the macro-economy affecting variables such as the demand for exports and imports; real GDP growth, inflation and unemployment – but as with most variables in economics, there are time lags involved.

1. The scale of any change in the exchange rate
2. Whether the change in the currency is short term or long term
3. How businesses and consumers respond to exchange rate fluctuations – elasticity of demand is important here!

Advantages of an appreciation in the currency

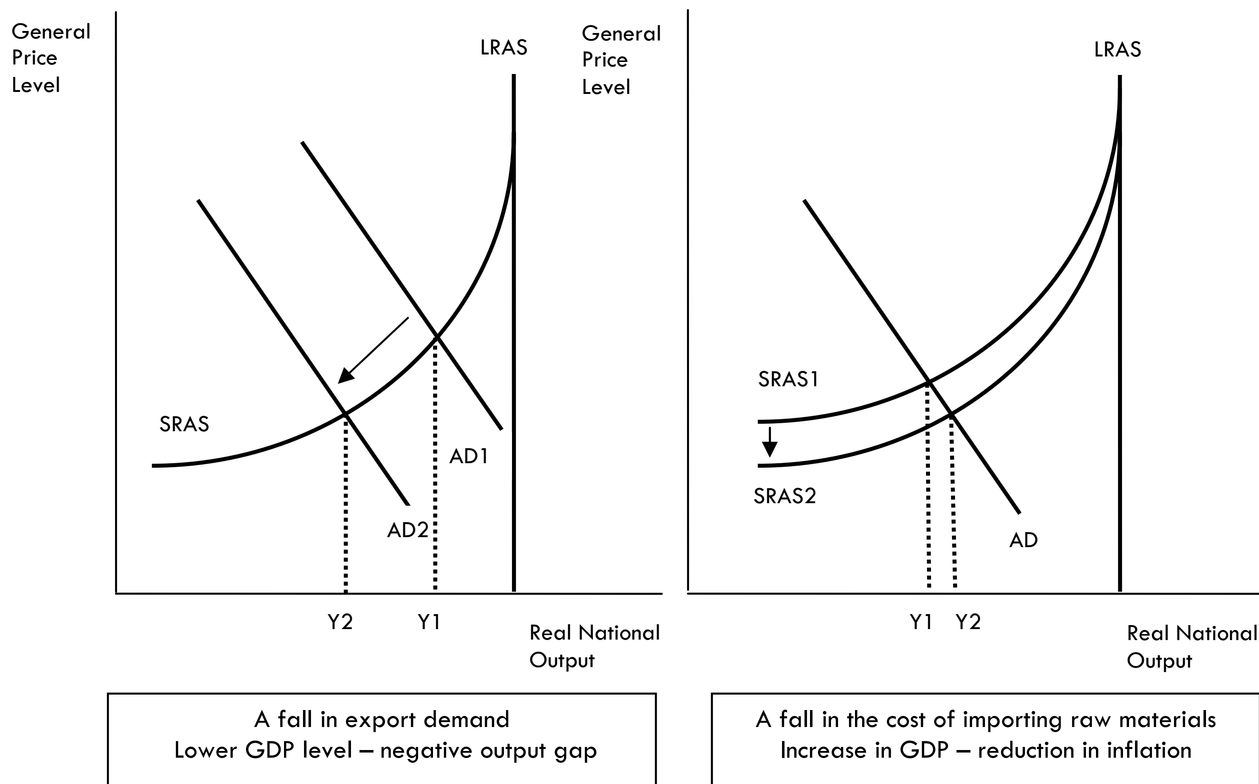
1. **Cheaper imports for consumers:** A high pound leads to lower import prices – this boosts the real living standards of consumers at least in the short run – for example an increase in the real purchasing power of UK residents when travelling overseas or the chance to buy cheaper computers from the United States or Europe.
2. **Lower production costs for producers**: When the sterling exchange rate is high, it is cheaper to import essential raw materials, component parts and capital inputs such as plant and equipment – this is good news for businesses that rely on imported components or who are wishing to increase their investment of new technology from overseas countries. A fall in import prices has the effect of causing an outward shift in the short run aggregate supply curve. And if a country can now import more productive technology, the long-run aggregate supply curve may shift outwards as well.
3. **Lower inflation**: A strong exchange rate helps to control the rate inflation because domestic suppliers now face stiffer international competition from cheaper imports and will look to cut their costs accordingly. Cheaper prices of imported foodstuffs and beverages will also have a negative effect on the rate of consumer price inflation.
4. **If inflation is lower, then interest rates will be lower** than if the exchange rate was weaker – and cheaper money will stimulate higher consumer spending and capital spending

Disadvantages of a Strong Pound

1. **Increase in the trade deficit:** The lower price of imports leads to consumers increasing their demand and this can cause a larger trade deficit. Exporters lose price competitiveness (because they will find it more expensive to sell in foreign markets) and face losing market share – this can damage profits and employment in some sectors. For example the high exchange rate had damaged employment in Britain in sectors such as textiles and clothing, car manufacturing and semi-conductor production as production has shifted away from the Uk towards countries with lower production costs
2. **Slower economic growth:** If exports fall, this causes a reduction in aggregate demand and reduces the short-term rate economic growth as measured by the % change in real GDP. Some regions of the economy are affected by this more than others. In the North east for example, manufacturing industry accounts for over 28% of regional GDP whereas the percentage for the UK as a whole is just 19%. So a strong exchange rate may threaten output, employment living standards more in some regions than others.

3. **If exports fall, then so will business confidence and capital investment** – because investment is partly dependent on the strength of demand

Modelling the effects of currency movements using AD-AS analysis



A fall in export demand
Lower GDP level – negative output gap

A fall in the cost of importing raw materials
Increase in GDP – reduction in inflation

Evaluation

Changes in the exchange rate have quite a powerful effect on the economy but we tend to assume **ceteris paribus** – all other factors held constant – which of course is highly unlikely to be the case

For example the government can alter fiscal policy to manage the level of AD and the Bank of England has the flexibility to change interest rates (e.g. lower rates if they felt that a high exchange rate was damaging export sectors and causing much lower inflation)

In the short term, the effects of exchange rates on export and import demand tends to be low because of low price elasticity of demand

Businesses can and do adapt to a high exchange rate. There are several ways in which industries can adjust to the competitive pressures that a strong pound imposes. Some of the options include:

1. Cutting their export prices when selling in overseas markets and therefore accepting lower profit margins to maintain competitiveness and market share

2. Out-sourcing components and raw materials from overseas to keep production costs down

3. Seeking productivity / efficiency gains to keep unit labour costs under control or perhaps trying to negotiate a reduction in pay levels

4. Investing extra resources in new product lines where demand is price inelastic and less sensitive to exchange rate fluctuations. This involves producing products with a higher income elasticity of demand, where non-price factors such as product quality, design and effective marketing are as important in securing orders as the actual price