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# Exchange Rates

Appreciation, devaluation and fixed exchange rates

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## Coverage

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- Stakeholder effects of appreciation
- Exchange-rate policy during recession
- Inflation, debt and export competitiveness

**Level-7 Econ Sample essays written by Ryan Reagan****Written by Ryan Reagan- the most popular IB Econ strategist in the world***\* Ryan's videos on Youtube have been watched by over 100,000 IB students world-wide***Topic 3.2: Exchange rate****Question:****Boom or bust**

- 1 The freely floating Australian dollar has been appreciating, creating winners and losers. Australian tourists overseas are getting bargain hotel rooms while some local exporters are suffering huge falls in demand. The **appreciation** of the Australian dollar gives a good reason to foreign students not to study in Australia. But as the Australian dollar continues to gain strength it seems that the economy is coping with the appreciating currency better than many economists expected.
- 2 Australia's exports are dominated by minerals, energy and agricultural products, and all are enjoying record prices. Continued strong demand means that the exporters of these products have not needed to look for other markets. For example, coal and iron ore prices have more than doubled in the last two years, these commodity prices rising even more quickly than the appreciating currency.
- 3 The Australian dollar is only one factor affecting exporters, and at the moment the strong economic growth of the Asian economies is adding to the increasing demand for Australian commodities.
- 4 However, not everyone in Australia is happy. Service industries have not enjoyed an increase in the price of their output, nor have they enjoyed booming foreign demand. The problems with the appreciating Australian dollar are most evident in the fact that fewer students and tourists are coming to Australia. Manufacturers have a similar problem and are suffering from the results of the rising Australian dollar and increased domestic interest rates.
- 5 The higher Australian dollar has provided many indirect benefits. By making imported resources cheaper, it has reduced the inflationary pressures which were caused by the economic boom that gave consumers greater spending power. As a result, it allowed the Australian government to slow down the **interest rate** increases which it was imposing in order to tackle inflation.

**Evaluate the possible effects of appreciation on the Australian economy (8 marks)**

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**01**

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This article discusses the effects of appreciation on various stakeholders in Australia.

There are a number of winners due to the appreciation in Australia. Firstly, like mentioned in the article, "Australian tourists overseas are getting bargain hotel rooms." This suggests that Australian tourists will have a higher purchasing power due to higher value of Australian dollar. Another benefit is that it lowers inflation. As mentioned in paragraph 5, the appreciation "by making imported resources cheaper, it has reduced inflationary pressures." When appreciation occurs, imports are cheaper in terms of the Australian dollars, which lowers cost of production and causes inflation to fall. This will benefit local producers as well, because they can enjoy lower cost of production and higher levels of profitability. Moreover, the appreciation also "allowed the Australian government to slow down the interest rate increases, which it was imposing in order to tackle inflation." Since appreciation already works to lower inflation, the Central bank would no longer need to increase interest rates to tackle inflation. This will benefit borrowers because it will slow down the increase in cost of borrowing.

There are also losers from the appreciation in Australian. As mentioned in paragraph 1, "some local exporters are suffering huge falls in demand." As the Australian dollar appreciates, exports will become more expensive in terms of foreign currencies. This will lead to a fall in demand for exports and a fall in export revenues. However, it is important to note that not all exporters suffer to the same extent. Like mentioned in the article, the demand for primary commodities from Asian is increasing because of higher levels of income in Asian countries. Thus, the appreciation will not have a noticeable effect on Australian exports of primary commodity. However, other producers such as service providers who are not enjoying an increase in demand from Asian are suffering more as a result of the appreciation of Australian dollar. For example, fewer foreign students are studying in Australia as it will cost more in terms of foreign currencies to study in Australia. Hence, schools in Australia will suffer from lower revenues.

In conclusion, appreciation benefits domestic consumers and domestic producers price of imports. On the other hand, exporters are worse off as they will suffer a fall in demand. There are winners and losers in this situation.

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- ❶ Badly hit by the financial crisis, Latvia is going through severe recession, losing 25 %–30 % of its Gross Domestic Product (GDP) in two years. It has very large budget and trade deficits, a large and growing public debt, and the deep recession has resulted in **deflation**.
- ❷ In view of these developments, the lat (Latvia's currency) would face **depreciation** in a freely floating exchange rate system. However, the lat has been pegged (fixed) to the euro since 2005 (0.7 lat : 1 euro). The Latvian government has shown its determination not to allow the lat to devalue. A stable currency relative to the euro is a condition for future adoption of the euro.
- ❸ Yet with very large trade and budget deficits, it has had to turn to the International Monetary Fund (IMF) and the European Union (EU) for loans. To qualify for the loans it has been forced to implement a highly restrictive fiscal policy, involving deep cuts in government spending on education and health care. Another government policy involves cutting wages in an effort to increase firms' export competitiveness.
- ❹ To maintain the pegged value of the lat, the Latvian central bank must keep interest rates at a relatively high level, in order to attract financial capital and prevent currency outflows. If the government devalued the lat, this could work to solve some of the problems. It would help correct the trade deficit and could also encourage economic growth. Economic growth might help reduce the public debt. A devaluation of the lat would also allow the government to pursue expansionary fiscal and monetary policies to deal with its deep recession.
- ❺ However, devaluation comes with risks. The government argues that it may create inflationary pressures due to higher import prices and a loss of export competitiveness. Widespread bankruptcies could arise because 85 % of consumer borrowing is in euros, meaning that the real value of consumer debt would increase.
- ❻ Estonia, Lithuania and Bulgaria (also with currencies pegged to the euro) may also devalue their currencies, reducing Latvia's competitive advantage from a devaluation of the lat.

**Evaluate Latvia's decision to fix its exchange rate (8 marks)**

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The article discusses how Latvia is going through a severe recession while it is aiming to fix its exchange rate. The fixed exchange rate prevents depreciation of the Lat.

Since Latvia is facing deflation and recession, fixing the exchange rate and preventing depreciation will have a negative effect on the economy. This is because depreciation will reduce export price and help to increase export demand while increases aggregate demand. The increase in aggregate demand will help to increase GDP and average price level, helping to end deflation and recession. In order "to maintain the pegged value of the lat, the Latvian central bank must keep interest rates at a relatively high level." The high interest rates help to increase the demand of the lat and maintain a high level of exchange rate. However, the high interest rate will actually work to worsen to recession because it will increase cost of borrowing, which reduces consumption, investment and aggregate demand. Moreover, devaluation of lat will also help to reduce public debt of the government, which allows the government to pursue expansionary fiscal policy. The use of expansionary fiscal policy will also help the economy to increase its GDP and help to end the recession. Overall, devaluation will help to Latvian economy to deal with the recession.

However, fixing the exchange rates also has several benefits. As mentioned in paragraph 2, "a stable currency relative to Euro is a condition for the future adoption of Euro." Fixing the exchange rate will allow Latvia to adopt the Euro. In paragraph 5, it also mentions that devaluation will lead to higher inflation. This is because when there is devaluation, the price of imports will be higher in terms of the Lat, which increases cost of production and leads to inflation. The higher import price can also lead to a loss of export competitiveness, because exporters that use imports as factors of production will suffer higher cost of production. Moreover, widespread bankruptcies could arise because 85% of borrowing is in Euro. If the Latvian currency devalues, the value of debt will increase in terms of Lat, which will lead to bankruptcies. Furthermore, if the Latvian currency is devalued, other countries such as Estonia and Bulgaria will retaliate by also devaluing their currency, which reduces Latvia's competitive advantage from devaluation. This means that even if Lat is devalued, it may not have a significant impact on increasing export demand since other countries will retaliate. Overall, the fixed exchange rate will help Latvia to adopt the Euro, lower inflation and reduce value of debt.

In conclusion, the main concern for Latvia's economy at the moment is the severe recession, losing 25-30% of GDP in just 2 years. If this recession continues, Latvian citizens will suffer a severe drop in standards of living. Hence, the cost of fixing the exchange rate outweighs the benefits in the current situation, because fixing the exchange rate prevents the government from using expansionary fiscal or expansionary monetary policy which are needed to end the recession.

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