Quick Answers

Question 1

Discuss whether or not a country should switch from a fixed foreign exchange rate system to a floating foreign exchange rate system.

Level 3: (6–8 Marks)
A reasoned discussion which accurately examines both sides of the economic argument, making use of economic information and clear and logical analysis to evaluate economic issues and situations. One side of the argument may have more depth than the other, but overall both sides of the argument are considered and developed. There is thoughtful evaluation of economic concepts, terminology, information and/or data appropriate to the question. The discussion may also point out the possible uncertainties of alternative decisions and outcomes.

Why it should:

- the government will not have to devote time and attention to maintaining the exchange rate and so may use policy measures to e.g. reduce inflation
- fewer foreign exchange reserves would have to be kept to maintain the exchange rate. These could be used to stimulate economic activity
- exchange rate may be lower which may increase economic growth, lower unemployment and improve the current account position

Why it should not:

- a lower exchange rate may cause inflation
- fluctuations in the exchange rate may create uncertainty. This may discourage investment and reduce economic growth
- may discourage MNCs from setting up in the country
- a higher exchange rate could reduce economic growth, employment and harm the current account position

Example of L3 answer:

A floating exchange rate changes with changes in demand and supply. A country should switch from a fixed foreign exchange rate system to a floating exchange rate system as there will be no need to keep foreign reserves so it can spend foreign reserves on something else. A country can easily change monetary policy changing interest rate without being worried. It can concentrate on other aims and not the exchange rate. Floating exchange rate automatically adjust current account of the balance of payments as increase in demand for exports will increase exchange rate reducing demand on exports. A country should not switch from fixed foreign exchange rate system to floating exchange rate as speculation could say that the value of local currency will decrease so people will sell it causing value to decrease as it will have lower demand. The uncertainty about export and import prices may discourage MNCs.

Principal Examiner comment:
Strong on one side and reasonable on the other.

Question 2

Analyse how a rise in a country's foreign exchange rate may affect its unemployment rate.

- A rise in the exchange rate will make exports more expensive (1) imports cheaper (1) demand for exports may fall / export revenue may decrease (1) demand for imports may rise / import expenditure may rise (1) net exports may fall (1) total (aggregate) demand may fall (1) output may decline (1) demand for labour may fall (1) unemployment may rise (1) cyclical unemployment (1)

Guidance

- Reward but do not expect reference to PED

Question 3

Explain, using information from the extract, why a depreciation of the kwacha harmed the Zambian economy.

- Inflation rate rose (1) from 10.1% in 2015 to 20.6% in 2016 (1).
- Growth rate fell (1) from 6.8% after 2014 (1).
- Depreciation is a fall in the value of the currency (1) import prices would have been higher (1) increasing costs of production (1) leads to higher prices (1) demand for higher wages (1) creating a wage-price spiral (1).

- Higher inflation may have reduced international competitiveness (1) reducing output / economic growth rate (1) leading to lower employment (1) and reduction in living standards (1).

Question 4

Define a floating foreign exchange rate.

- The price of a currency (1) determined by market forces (1)

Question 5

Discuss whether or not a government should prevent a fall in its country's foreign exchange rate.

Up to 5 marks for why it should:

- A fall in the exchange rate would increase the price of imports (1) this will increase the price of imported raw materials (1) this will increase costs of production (1) inflation may occur (1).

- A rise in the price of finished products (1) will reduce the goods and services people can buy (1) reduce living standards (1).

- A fall in the exchange rate may reduce confidence in the country (1) this may reduce investment (1).

- A lower exchange rate may increase debt repayments (1) making it more difficult for firms and the government to pay back loans (1).

- Higher government spending on e.g. state benefits (1) will increase disposable income (1) some of this might be spent on imports (1).

Up to 5 marks for why it should not:

- A lower exchange rate will reduce the price of exports (1) more exports may be sold (1) this combined with lower imports may improve the current account balance (1).

- Demand for domestic products may rise (1) this may increase output (1) so cause economic growth (1) reduce unemployment (1).

Question 6

Analyse two consequences of a depreciating foreign exchange rate.

- price of exports decreases (1) quantity of exports demanded increases (1) value of exports increases (1) net exports increase (1)
- price of imports increases (1) quantity demanded for imports decreases (1) value of imports decreases (1)
- current account deficit decreases / surplus increases (1) total (aggregate) demand increases (1) inflation increases (1)
- price of imported raw materials / semi-finished goods increases (1) cost of production increases (1) price level increases / inflation (1)
- discourages savers from overseas (1) who fear losing money (1)

Guidance

- Maximum of 4 marks if only one consequence analysed

Question 7

Discuss whether or not a fall in its foreign exchange rate will benefit an economy.

Up to 5 marks for why it might:

- A lower exchange rate will reduce the price of exports (1) raise the price of imports (1) net exports may rise / exports may rise / imports may fall (1) current account of the balance of payments may improve (1) total (aggregate) demand may increase (1) real GDP may increase economic growth (1) employment may rise (1)

Up to 5 marks for why it might not:

- Higher import prices may not reduce spending on imports if demand for imports is inelastic (1) export revenue may not rise if demand for exports is inelastic (1) import restrictions imposed on other countries may make it difficult to sell more exports (1)

- Higher import prices may cause inflation (1) imported raw material costs may rise (1) causing cost-push inflation (1) imported finished products may not be replaced by domestic products (1) rise in net exports may cause demand – pull inflation (1)
- Domestic citizens may be able to purchase fewer imports (1) lower living standards (1)
- If the country is in debt (1) it may increase the cost of repaying the debt (1)
- If the country is operating at full employment (1) it may not be possible to produce more exports / substitutes for imports (1)
- Demand for the country's exports may be low (1) if quality is poor / incomes abroad are falling abroad (1)
- If the fall is used as a way to capture markets abroad / protect domestic industries (1) there may be retaliation (1)

Guidance

- Each point may be credited only once, on either side of an argument, but separate development as to how/why the outcome may differ is expected.

Question 8

Analyse what may cause a depreciation in an exchange rate

- A deficit on the balance of payments on current account (1) imports are greater than exports resulting in fall in market price (1)
- A fall in demand for the currency (1) a rise in the supply of the currency (1)
- A fall in exports/rise in imports (1) due to higher inflation (1) lower quality of goods being produced (1) higher costs of production (1)
- A rise in imports/fall in exports (1) due to increase in demand in the economy/economic growth (1
- A fall in the rate of interest (1) due to a fall in FDI/speculation (1)
- An expansionary government monetary policy (1) to sell currency to encourage exports (1)

Question 9

Define devaluation

- A fall in the value (1) of a (fixed) exchange rate (1)
- Fall in value of currency (1) relative to another (1)
- Fall/decrease in exchange rate (1)
- Fall/decrease in currency (0)

Guidance

- 'Exchange rate' means one currency relative to another
- 'Currency' means one currency on its own – mark as Too Vague

Question 10

Explain TWO advantages of a floating exchange rate.

- It should automatically eliminate current account imbalances (1) by floating down when there is a deficit (1)
- No currency reserves are needed (1) as the government will not intervene to influence the value of the currency (1)
- No government intervention needed (1) as the exchange rate will be at the market price / determined by supply and demand (1)
- The exchange rate is not a policy target (1) policy measures do not have to be used to influence its value (1)

Question 11

Discuss whether or not an exchange rate depreciation will prevent an economy from experiencing a recession.

Up to 5 marks for why it might:

- Depreciation means foreign consumers have to exchange less units of their currency for one unit of domestic currency (1), making exports cheaper (1) raising export demand (1) and imports more expensive (1) reducing demand for imports (1) as domestic consumers will find domestic goods and services relatively cheaper (1)

- Firms have more domestic and foreign demand (1) and will increase output to meet this demand (1) preventing a recession (1)

- Net exports will increase (1) increasing aggregate demand (1)

Up to 5 marks for why it might not:

- Demand for imports may be inelastic (1) and a depreciation will not have a great effect (1)

- Demand for exports may be inelastic (1) so export demand will not boost output (1)

- If there is a recession in main export markets then demand for exports may still fall (1) even if they are now relatively cheaper (1)

- It may cause cost-push inflation (1) as domestic firms have to pay more for imported inputs (1)

- Depreciation may worsen investor confidence (1) reducing investment and causing a recession (1)

Question 12

Identify, using information from the extract, two ways a central bank could try to stop a fall in the international value of its currency.

- Increase interest rate (1)

- Sell its foreign reserves / buy its own currency (1)