Friday 29th November

12th Grade | Economics Homework | IB Economics

a) Discuss the factors which determine freely floating exchange rates.
b) Discuss the view that an appreciation of the currency is always beneficial and depreciation always harmful.

A freely floating Exchange Rate is an exchange rate with no government or central bank action to keep it stable, this means that the determination of the exchange rate is left to market forces.

On one hand, the appreciation of the currency is when the exchange rate is subject to an increase meaning that the currency of the country buys more of all other foreign currencies.

On the other hand, a depreciation of the currency leads to a fall in the exchange rate therefore the currency of the domestic country buys less than all other foreign currencies.

Two parts will be attributed to this essay, the first being the discussion of the factors that determine freely floating exchange rates, then the discussion of whereas an appreciation of the currency is always beneficial or not and whereas a depreciation is always harmful or not.

The advantages of a floating exchange rate system are the exchange rate automatically adjusts so that supply of the currency equals demand. It has to be taken into account that this will neutralize any balance of payments deficit or surpluses. If imports rise, for example, the supply of the domestic currency increases leading to a fall in the exchange rate. Therefore, if the domestic currency falls, there will be a rise for domestic produced goods and services by foreign countries consequently a rise in exports which will automatically eliminate deficit.

Another advantage of this free floating exchange rate is that there is no need for the central bank to keep foreign reserves. Plus, the Government can pursue its own domestic policies for example the adjustment of interest rates becomes easier.

The freely floating exchange rate can nevertheless create instability in which deters investment and trade.

A disadvantage of the free floating exchange rate is that it can lead to inflation which makes its goods uncompetitive; this will lead to a fall in demand for its currency and a fall in the exchange rate. This makes its good competitive again but makes imports more expensive, which in the long run will lead to more inflation.

Purchasing Power parity is another important notion that free floating exchange rates encounter. Purchasing Power Parity is the law of one price where one good must be sold at the same price everywhere. For example, if the cost of coffee is lower in Japan that in the U.S., people will buy coffee in Japan and sell it in the U.S. so that they can profit from it. Nevertheless, this profit will only be in the short-run because in the long-run, the price will stabilize because the price of coffee in the U.S. will decrease and the price of coffee in Japan increase therefore this will lead to an equilibrium of prices where the price of coffee in Japan will be the same than the one in the U.S..

If the currency appreciates, it is true that the value of the currency will increase giving the country a more powerful exchange rate. For an appreciation to happen the demand of the currency has to increase and the imports decrease.

By looking first at inflation with an appreciation of the currency it can be noted that inflation will decrease because the country's exports will become more competitive if the currency is appreciating and therefore the imports will be less competitive leaving us with a rise in demand and a fall in supply of the currency. Consequently, there will be a lower inflation rate.

Another positive aspect of inflation is that because the currency is appreciating, foreigners will want to put their savings in domestic banks, this means higher interest rates leading to a rise of demand for the domestic currency and a fall of the supply in the domestic currency because domestic people will want to benefit from the high interest rates domestically.

Speculation is one other aspect which can benefit the currency when it is appreciating. Indeed, when the speculators see that the domestic currency is appreciating, they will speculate that the domestic currency will rise more and more so that people will demand more domestic currency leading to a demand for the currency and a fall in the supply of the currency because banks will only buy that currency.

If the domestic currency is appreciating, foreign investors will want to invest more so there will be an increase in demand of the currency and a decrease in supply of the currency because domestically, investors will want to invest domestically.

It is true that the depreciation is always harmful; in fact, there are some major factors which confirm this affirmation.

The first major cause of depreciation is that Interest rates will domestically fall. This is caused because if the currency depreciates, domestic savers will no longer want to deposit money into domestic bank but would place their savings in countries abroad therefore the supply for the domestic currency rises and on the other hand foreigners will not want to put their savings in this particular country leading to a fall in the demand for the domestic currency.

Another negative aspect of a depreciation of the currency is that speculation that the exchange rate might fall will lead to a rise of the supply of the domestic currency because, because of this speculation, the foreign exchange dealers will sell the currency thinking that it will fall.

Because of this depreciation, it can also be seen that the inflation domestically will be higher than abroad leading to a fall in demand for the currency thus the imports will be cheaper to buy than domestic produced goods therefore the supply for the currency will rise leading to a perfect example of inflation.

Another disadvantage of this depreciation of the currency is that if the prospects for investment are better abroad, a domestic citizen will invest abroad leading to a fall in demand and a rise in supply of the currency.

In conclusion, it can be said that the freely floating exchange rate has more advantages than disadvantages which make it a good theory to adapt in real life whereas in the other we have confirmed that an appreciation has only positive aspects which can benefit the currency and a depreciation in the currency is very harmful for a country's currency because of its negative aspects.