2.21 Exchange Rate Systems and the Determination of Floating Rates: Test Pack

Total Marks

AQA 7136 · Calculators not allowed · about 15 minutes

Name: _____ Date: ____ / ____ / _____

Answer all questions. The diagram question and the final 25-mark essay should be answered in full sentences. No calculator is allowed. Time guidance: 15 minutes.

1 Multiple choice: In the context of the foreign exchange market for sterling (£) against the euro (EUR), which of the following best describes a floating exchange rate system for the UK?

- ☐ The central bank fixes the GBP/EUR rate and trades unlimited quantities of currency to keep it fixed.
- ☐ The GBP/EUR exchange rate is determined by supply and demand in foreign exchange markets with no commitment to a fixed rate.
- ☐ The government sets a one-time official GBP/EUR rate that can only be changed by parliamentary vote.
- ☐ Commercial banks decide a daily official GBP/EUR rate and the central bank intervenes in all trades.

(Total for Question 1 is 1 mark)

2 Distinguish between an appreciation and a depreciation of a currency under a floating system and a revaluation and a devaluation under a fixed system. Give one short example phrase for each pair.

(Total for Question 2 is 3 marks)

3 Define a floating exchange rate system in the context of a national currency such as sterling (£).

(Total for Question 3 is 1 mark)

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4 Explain briefly how a higher UK interest rate, relative to other countries, tends to affect demand for sterling (£) in the foreign exchange market. Name the mechanism and one short implication.

(Total for Question 4 is 3 marks)

5 Explain briefly how speculative hot-money flows can cause rapid short-term movements in a floating exchange rate. Give one example of a trigger for such flows.

(Total for Question 5 is 2 marks)

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Mark scheme · 2.21 Exchange Rate Systems and the Determination of Floating Rates: Test Pack

Question 1

selects the option stating that the exchange rate is set by market supply and demand with no binding commitment to a fixed rate — **B1**

Answer: The GBP/EUR exchange rate is determined by supply and demand in foreign exchange markets with no commitment to a fixed rate.

Question 2

defines appreciation/depreciation: market-driven rise/fall in the currency's value under a floating rate — **M1**

defines revaluation/devaluation: a deliberate official change in the fixed parity up or down by the monetary authority — **M1**

gives brief examples, e.g. appreciation: sterling rises from 1.10 to 1.20 EUR per GBP; devaluation: government lowers the fixed parity from 1.10 to 1.00 EUR per GBP — **A1**

Answer: Appreciation/depreciation are market-driven increases/decreases in value; revaluation/devaluation are official changes in a fixed parity. Examples given for each pair.

Question 3

a system where the currency's value is determined by market forces of demand and supply in foreign exchange markets, with no fixed official parity — **B1**

Answer: A system where the currency's value is set by market demand and supply in foreign exchange markets with no fixed official parity.

Question 4

identifies the mechanism: higher UK interest rates attract portfolio and hot-money capital seeking higher returns — **M1**

explains that foreign and domestic investors increase demand for GBP to buy UK assets, raising demand for sterling in the FX market — **A1**

states the implication: increased demand tends to cause sterling to appreciate, other things equal — **B1**

Answer: Higher UK interest rates attract capital seeking higher returns, increasing demand for GBP to buy UK assets, which tends to cause sterling to appreciate.

Question 5

explains that speculators move large sums quickly to chase expected gains from interest rate or expected exchange rate changes, altering demand and supply for the currency — **M1**

gives an example trigger, e.g. news of an unexpected central bank rate rise, a sudden political shock, or a change in market expectations causing rapid inflows or outflows — **A1**

Answer: Speculators shift large sums rapidly to profit from expected rate changes, quickly changing demand or supply for sterling; a trigger could be an unexpected interest rate announcement.

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