2.21 Exchange Rate Systems and the Determination of Floating Rates

AQA 7136 · Calculators not allowed · about 60 minutes · Write-in edition

Total Marks

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: 60 minutes.

1 Foreign exchange market diagram task, context UK spot market for sterling (£) against the euro (EUR). Draw a supply and demand diagram for GBP priced in EUR with exchange rate on the vertical axis and quantity of GBP on the horizontal axis. The Bank of England unexpectedly raises UK interest rates above those in the euro area. Show and label the initial equilibrium and the effect of the interest rate rise. Identify the new equilibrium exchange rate direction and the correct shift. Explain your diagram in one sentence.



(Total for Question 1 is 4 marks)

2 State one advantage for UK exporters of a fixed exchange rate system. Explain briefly why this advantage may matter for trade decisions.

(Total for Question 2 is 2 marks)

3 Evaluate the view that a floating exchange rate system is better suited to the UK economy than a fixed exchange rate system.

(Total for Question 3 is 25 marks)

4 Define a fixed exchange rate system for a national currency such as sterling (£).

(Total for Question 4 is 1 mark)

5 Define a managed exchange rate (also called a managed float) for a currency such as sterling and give one brief example of how it differs from a pure float.

(Total for Question 5 is 1 mark)

6 Percentage change calculation: In January the market rate is £0.80 per EUR. By July the market rate is £0.88 per EUR. Calculate the percentage change in the value of the pound measured in GBP per EUR between January and July and state whether sterling has appreciated or depreciated against the euro. Context: rates quoted are GBP per EUR so a higher number means one euro costs more GBP.

(Total for Question 6 is 3 marks)

7 Explain how a persistently higher UK inflation rate relative to trading partners affects the supply of sterling in the foreign exchange market and the likely direction of sterling in a floating regime. Give one clear reason.

(Total for Question 7 is 2 marks)

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8 Explain briefly how a rise in UK exports, other things equal, affects demand and supply of sterling in the foreign exchange market and the likely direction of sterling under a floating rate.

(Total for Question 8 is 2 marks)

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

Question 1

labels axes correctly: exchange rate (EUR per GBP) vertical, quantity of GBP horizontal	**B1**
shows initial equilibrium point E1 where D1 and S1 intersect	**B1**
correctly shifts demand for GBP to the right (D1 to D2) to reflect higher UK interest rates attracting capital	**B1**
shows new equilibrium E2 with a higher exchange rate (EUR per GBP) indicating sterling appreciates	**B1**

Answer: Diagram shows D shift right to D2, new equilibrium E2 at a higher EUR/GBP rate; sterling appreciates.

Question 2

states an advantage, e.g. greater exchange rate stability/predictability for exporters' revenues and pricing	**B1**
explains why: reduces exchange rate risk so firms can plan prices, contracts and investment with less hedging cost	**B1**

Answer: Fixed rates give exporters exchange rate stability, reducing uncertainty about future revenues and lowering the need for costly hedging when setting export prices and contracts.

Question 3

Level 1 Basic statements about floating or fixed exchange rates with little application to the UK. Limited development and no sustained analysis or judgement.	**1-5**
Level 2 Some explanation of advantages and disadvantages of floating and fixed regimes with some application to the UK context. Arguments start to be developed, but evaluation is limited and judgement is not well supported.	**6-10**
Level 3 Clear analysis of benefits and costs of floating and fixed systems, applied to the UK economy with relevant examples. Balanced evaluation considering practical constraints and trade offs, and a supported conclusion.	**11-15**
Level 4 Thorough analysis with multiple developed lines of argument applied to the UK, including monetary policy autonomy, external shocks, credibility and reserves issues. Counterarguments addressed and judgement well supported with evidence and reasoning.	**16-20**
Level 5 Excellent, balanced evaluation drawing on a wide range of evidence and economic reasoning, explicit consideration of short run versus long run trade offs, distributional effects and policy constraints, and a well-justified final judgement on which regime better suits the UK.	**21-25**

Indicative content:

- Advantages of floating for the UK: monetary policy independence allowing the Bank of England to set interest rates to meet domestic objectives such as inflation targeting and stabilising output; automatic adjustment to external shocks via exchange rate movements; less need to hold large foreign exchange reserves; reduces risk of speculative attacks if policy credible.
- Disadvantages of floating: greater short-run exchange rate volatility that can increase uncertainty for firms and financial markets, potential for disruptive hot-money flows and rapid appreciation or depreciation, and possible pass-through of exchange rate volatility to inflation.
- Advantages of fixed for the UK: exchange rate stability reduces transaction and hedging costs for exporters and importers, anchors inflation expectations if credibility is enhanced, may support lower long-term interest rates if credible peg is maintained.
- Disadvantages of fixed: loss of monetary policy autonomy, requirement to intervene and hold substantial foreign reserves, vulnerability to speculative attacks if parity inconsistent with fundamentals, need for fiscal or interest rate adjustments to defend the peg which can be costly.
- Practical considerations for the UK: the openness and size of the UK financial sector and its role in global capital markets make capital mobility high, which weakens the feasibility of a fixed regime without capital controls; the UK economy faces frequent external shocks (commodity, financial cycles, global demand) where a floating rate can act as a shock absorber; credibility and institutional capacity to maintain a durable fixed peg would require strong fiscal discipline and large reserves.
- Evaluation points: trade offs between short-term stability and long-term policy independence; the likely effectiveness of sterilised interventions; distributional effects (who gains from a stable rate versus who benefits from flexible adjustment); the role of modern financial instruments and hedging in reducing exporter risk under floating rates; evidence from other countries and historical UK experience of fixed pegs and costs involved.
- Judgement: weighing the above, a supported conclusion about which regime better suits the UK, possibly conditional (e.g. floating preferable given open capital markets and need for monetary autonomy, but with measures to reduce volatility such as a managed float or credible macro policy framework).

Question 4

a system where the monetary authority pegs the currency to another currency or basket and intervenes to keep the exchange rate at the chosen parity	**B1**

Answer: A system where the monetary authority pegs the currency to another currency or basket and intervenes to maintain that parity.

Question 5

a system where the exchange rate is usually market-determined but the central bank occasionally intervenes to smooth volatility or steer the rate **B1**

Answer: A system where the exchange rate is mainly set by markets but the central bank sometimes intervenes to reduce volatility or guide the rate.

Question 6

uses the formula (new - old) / old x 100 with the given exchange rates: (0.88 - 0.80) / 0.80 x 100 **M1**

correct percentage change = 10% (showing working); accept a 9.1% fall in the pound's euro value if the candidate converts to EUR per GBP (1/0.80 = 1.25 to 1/0.88 = 1.136) **A1**

correct direction: sterling has depreciated against the euro because GBP per EUR rose from 0.80 to 0.88 **B1**

Answer: Percentage change = (0.88 - 0.80) / 0.80 x 100 = 10%. Sterling has depreciated against the euro.

Question 7

identifies mechanism: higher UK inflation reduces competitiveness, making imports relatively cheaper and exports less competitive **M1**

explains result: households and firms import more and exports fall, increasing supply of sterling for foreigners to sell and tending to cause sterling to depreciate **A1**

Answer: Higher UK inflation relative to partners tends to increase imports and reduce exports, increasing supply of sterling on FX markets and tending to cause sterling to depreciate.

Question 8

identifies mechanism: an increase in exports means foreigners need more sterling to pay for UK goods **M1**

explains outcome: increased demand for sterling tends to cause sterling to appreciate under a floating exchange rate **A1**

Answer: Higher exports increase foreigners demand for sterling to pay for UK goods, raising demand for sterling and tending to cause it to appreciate.