AQA A-LEVEL ECONOMICS · 7136

ECONOMICS



EXAM QUESTION PACK

3.2.6.4 EXCHANGE RATE SYSTEMS

SCORE	PERCENTAGE
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1. In January 2009, £1 could buy approximately 1.04 euros on the foreign exchange market. By July 2015, £1 could buy approximately 1.44 euros.

Explain the factors that may lead to a rise in the exchange rate of a currency.

[15 marks]

2. In 2014, the UK's contributions to the European Union (EU) budget rose by £2.7bn, making it the second largest net contributor. However, it is argued that the UK benefits much more from the trade and the job creation that EU membership brings.

Explain how membership of a customs union, such as the EU, affects the pattern and volume of trade between countries.

[15 marks]

3. 'George Osborne talks about boosting exports and rebalancing the economy, but the Chancellor is not nearly as worried about the trade deficit as he is about the budget deficit.'

To what extent do you agree that a persistent trade deficit is more damaging to the UK's macroeconomic performance than a persistent budget deficit? Justify your answer.

[25 marks]

4. **Extract C** (lines 2 – 4) asks: 'Is it time the UK considered manipulating its currency directly and managing its exchange rate in order to reduce the ever-increasing trade deficit and to help improve its performance?'

Using the data and your knowledge of economics, evaluate the view that the UK should focus its monetary policy on managing the exchange rate in order to improve macroeconomic performance.

[25 marks]

5. Explain the phrase 'devaluation of the exchange rate' (**Extract B**, line 12) **and**, with the help of a diagram, analyse how a devaluation of the Chinese currency (the yuan) may affect economic growth in the UK.

[9 marks]

6. In January 2009, £1 could buy approximately 1.04 euros on the foreign exchange market. By July 2015, £1 could buy approximately 1.44 euros.

Evaluate the impact on the UK's macroeconomic performance of a sustained rise in the value of the pound sterling against the euro.

[25 marks]

7. Using the data in **Extract A**, calculate (to one decimal place) the percentage change in the exchange rate between the **US dollar** and the **Chinese yuan** between 1 August 2015 and 13 August 2015.

[2 marks]

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8. **Essay 1**

The UK has been running a deficit on its balance of trade in goods and services since 1998. Expenditure-reducing and expenditure-switching policies can both be used to correct a trade deficit. However, the UK government has focused on other objectives rather than achieving a trade balance.

Explain how expenditure-switching policies can be used to reduce a deficit on a country's balance of trade in goods and services.

[15 marks]

9. The UK has seen significant changes in its pattern of trade with the rest of the world in terms of what we trade and with whom. The UK's current account deficit widened from £29.1bn in 2011 to £100.2bn in 2015. The deficit in 2015 was 5.4% of GDP, the largest annual deficit as a percentage of GDP since records began in 1948.

Explain the possible reasons for changes in the pattern of trade between the UK and the rest of the world.

[15 marks]

10. The UK has seen significant changes in its pattern of trade with the rest of the world in terms of what we trade and with whom. The UK's current account deficit widened from £29.1bn in 2011 to £100.2bn in 2015. The deficit in 2015 was 5.4% of GDP, the largest annual deficit as a percentage of GDP since records began in 1948.

Evaluate the measures that might be taken to reduce a deficit on the current account of the UK's balance of payments.

[25 marks]

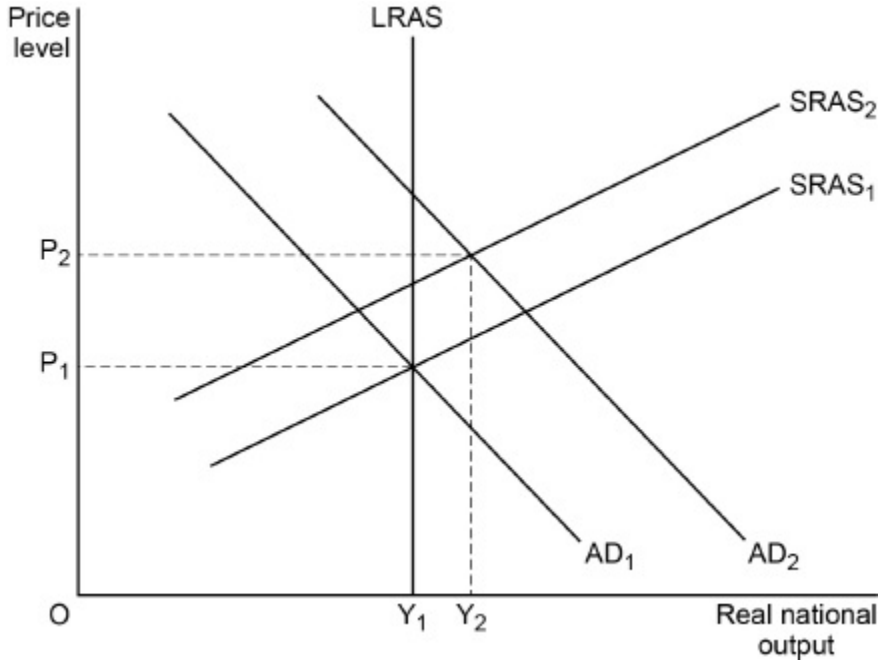
11. **Extract F** (lines 19–20) states 'What is not clear is what should be done if low inflation turns to bad deflation.'

Using the data in the extracts and your knowledge of economics, evaluate the view that monetary policy is the most effective way of tackling deflation in developed economies such as the UK and Japan.

[25 marks]

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12. The diagram below shows two aggregate demand (AD) curves, two short-run aggregate supply (SRAS) curves, and the long-run aggregate supply (LRAS) curve for an economy.



The increase in the price level from P_1 to P_2 raises the rate of inflation above the target rate set by the government. In an attempt to bring inflation back to its target rate, the central bank announces a change in interest rates. Other things being equal, this is most likely to

A create upward pressure on the exchange rate. ⬭

B increase bond prices. ⬭

C make business loans more affordable. ⬭

D reduce the cost of servicing the national debt. ⬭

[1 mark]

13. **Extract B** (lines 21) states 'Although some argue that a current account deficit is not a problem, others point to the worryingly large and persistent nature of the deficit.'

Using the data in the extracts and your knowledge of economics, assess the impact of a persistent current account deficit on the macroeconomic performance of the UK economy.

[25 marks]

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14. The table below shows the average exchange rate and currency valuation estimates for four nations in comparison to the US Dollar in January 2016.

	Average exchange rate to US $1	Currency valuation estimate
Australian Dollar	1.46	Undervalued by 24%
Brazilian Real	4.05	Undervalued by 32%
Chinese Yuan	6.57	Undervalued by 46%
Danish Krone	6.84	Undervalued by 12%

Which one of the following can be concluded from the data?

A The Australian Dollar has appreciated by 24% against the US Dollar. ⬭

B The Brazilian Real has been devalued by 32% against the US Dollar. ⬭

C The Chinese Yuan has depreciated the most against the US Dollar. ⬭

D The Danish Krone has the closest purchasing power parity to the US Dollar. ⬭

[1 mark]

15. **Extract C** (lines 8–9) states 'Trade deficits and surpluses may be self-correcting in a floating exchange rate system.'

With the help of a diagram showing the supply of and demand for a currency, explain how a floating exchange rate may help to correct a trade surplus.

[9 marks]

16. **Extract B** describes the trade figures as 'disappointing'.

Explain how the data in **Extract A (Figure 2)** show that the UK's trade performance has been 'disappointing' given the fall in the value of the pound since November 2015.

[4 marks]

17. Using the data in **Extract A (Figure 1)**, calculate the change in the effective exchange rate index, as a percentage, between November 2015 (point A) and November 2016 (point B). Give your answer to **two** decimal places.

[2 marks]

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18. A country experiences a large net capital outflow. All other things being equal, the most likely consequence of this in the short run will be a decrease in

A its exchange rate. ⬭

B its net income from overseas investments. ⬭

C its rate of interest. ⬭

D the value of exports and imports. ⬭

[1 mark]

19. Between 2014 and 2018, the pound fell by more than 20% against the dollar and euro. Some argued that this would benefit the UK's macroeconomic performance, but others claimed that a lower exchange rate will cause problems.

Assess the view that a depreciation of the pound against other currencies is likely to improve the UK's macroeconomic performance.

[25 marks]

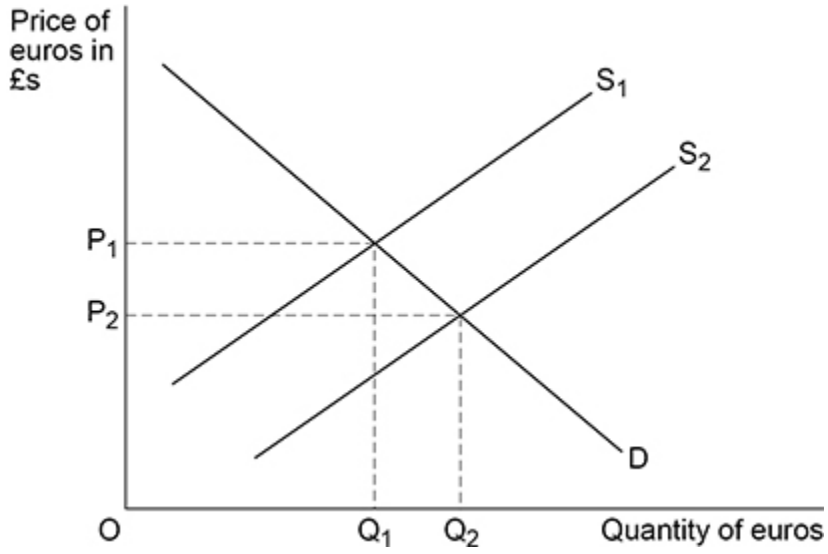
20. Between 2014 and 2018, the pound fell by more than 20% against the dollar and euro. Some argued that this would benefit the UK's macroeconomic performance, but others claimed that a lower exchange rate will cause problems.

Explain why the value of a currency may fall in a floating exchange rate system.

[15 marks]

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21. The graph shows two supply (S_1 and S_2) curves and the demand (D) curve for euros on the foreign exchange market and the price of euros in terms of pounds sterling.



Which one of the following is the most likely explanation for the change in the exchange rate shown in the graph above?

An increase in eurozone

A companies buying factories in the UK. ⬭

B exports of manufactured goods to the UK. ⬭

C interest rates relative to those in the UK. ⬭

D productivity growth relative to that in the UK. ⬭

[1 mark]

22. In 2015, Lithuania joined the eurozone, adopting the euro as its currency. Since then, the euro has appreciated by more than 15% against the pound sterling. Some have argued that this will reduce economic growth in Lithuania and other countries within the eurozone.

Evaluate the costs and benefits for a country of joining a currency union, such as the eurozone.

[25 marks]

23. In 2015, Lithuania joined the eurozone, adopting the euro as its currency. Since then, the euro has appreciated by more than 15% against the pound sterling. Some have argued that this will reduce economic growth in Lithuania and other countries within the eurozone.

Explain how an appreciation of its currency is likely to affect a country's rate of economic growth.

[15 marks]

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24. Since 1992, the UK has had a floating exchange rate, and between August and December 2019, the pound sterling rose by around 10%. In the recent past, several nations, such as Japan, Switzerland and China, have actively intervened to influence the value of their currencies.

Evaluate the possible impact on the cost of living **and** the standard of living in the UK of a sustained rise in the value of the pound sterling against other currencies, such as the euro and the US dollar.

[25 marks]

25. **Essay 3**

Over the past 20 years, the growth of world trade has averaged 6% per year, twice as fast as the growth in world output. As countries become ever more interconnected, they experience both economic opportunities and threats.

Explain reasons for changes in the value of exports from the UK to the rest of the world.

[15 marks]

26. Since 1992, the UK has had a floating exchange rate, and between August and December 2019, the pound sterling rose by around 10%. In the recent past, several nations, such as Japan, Switzerland and China, have actively intervened to influence the value of their currencies.

Explain how a government or central bank can intervene to prevent the value of its currency rising.

[15 marks]

27. **Extract F** (lines 7–8) states: 'Economists said the data reinforced the view that the slump in South Korea's trade-reliant economy would continue beyond this year'.

Using the data in the extracts and your knowledge of economics, evaluate policies which could be used to boost South Korea's exports and increase its trade surplus.

[25 marks]

28. Explain the factors that a commercial aircraft manufacturer, such as Boeing or Airbus, should consider when forecasting the future sales of its aircraft.

[15 marks]

29. When using data to make international comparisons of the standard of living, purchasing power parity (PPP) exchange rates are more useful than market exchange rates.

This is because PPP exchange rates take into account differences in countries'

A distribution of income. ⬭

B levels of taxation. ⬭

C price levels. ⬭

D rates of population growth. ⬭

[1 mark]

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30.

Essay 1

The UK has been running a deficit on its balance of trade in goods and services since 1998. Expenditure-reducing and expenditure-switching policies can both be used to correct a trade deficit. However, the UK government has focused on other objectives rather than achieving a trade balance.

Assess the view that floating exchange rates are always better than fixed exchange rates.

[25 marks]

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1. ‘When the exchange rate of a country’s currency causes problems, it may be down to free market forces, but government intervention might be to blame.’

Explain **three** possible determinants of a country’s exchange rate against other currencies.

[15 marks]

2. **The European Union Context Extract D** (lines 28–29) states that it ‘is difficult to predict what the economic impact on the UK might be should there be a break-up of the eurozone’.

Using the data and your economic knowledge, assess the possible impact on the UK economy if a number of countries leave the eurozone.

[25 marks]

3. Using **The European Union Context Extract C**, calculate the price in dollars of a good exported from the eurozone to the US at the start of 1999 priced at 20 euros **and** identify **one** significant feature of the dollar/euro exchange rate for the period 1999 to 2011.

[2 marks]

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4. THE EUROPEAN UNION CONTEXT

Extract D: Can the eurozone survive?

Before the global recession of 2008, the euro had emerged as a successful major currency, making travel and trade for member countries much easier. Those countries traditionally with weaker currencies, such as Italy, Greece and Spain, were given a degree of stability which fostered economic growth. Some leading economists and politicians were urging the UK to adopt the euro, seeing it as a major step towards the full integration of the UK into the European Union (EU).

The global recession changed everything. By 2011, there were many in the UK relieved that we were still outside the eurozone. The growing debt crisis in the eurozone has inevitably had repercussions for the euro. Stronger members found themselves being called upon to offer financial support to those economies in trouble. Media reports began to suggest that the ultimate outcome of the debt crisis would be the break-up of the eurozone, with some of the weaker members such as Spain, Italy and Greece re-adopting their former national currencies.

The UK Government has adopted a policy of fiscal restraint in order to reduce annual borrowing and to try to limit the growth of the National Debt (the total outstanding debt of the government). It urged the weaker members of the eurozone in particular to adopt a similar policy if they were to retain membership.

However, the potential benefits of leaving the eurozone are not lost on some politicians and economists within the weaker economies. One such benefit is the absence of the same 'one-size-fits-all' interest rate. For example, some countries still in recession in the eurozone saw their interest rates, as set by the European Central Bank, rise to 1.25% in July 2011. This was at a time when the Bank of England kept the UK Bank Rate at 0.5%. Countries could also restore an exchange rate for their own currencies which would give them a competitive edge, rather than being forced to cut wages and jobs. They would also not be obliged to follow such a strict policy of fiscal restraint which remaining members would have to follow.

There are others, however, both within these countries and beyond, who warn against departure from the eurozone. It is difficult to predict what the economic impact on the UK might be should there be a break-up of the eurozone. The impact would depend on a number of factors, including how many countries left and which countries these were. It might also depend on the degree of economic instability which departure from the eurozone might cause in those countries as they restored their national currencies, and the impact on the stability of the remaining members of the eurozone. It has to be borne in mind, however, that the EU would still exist.

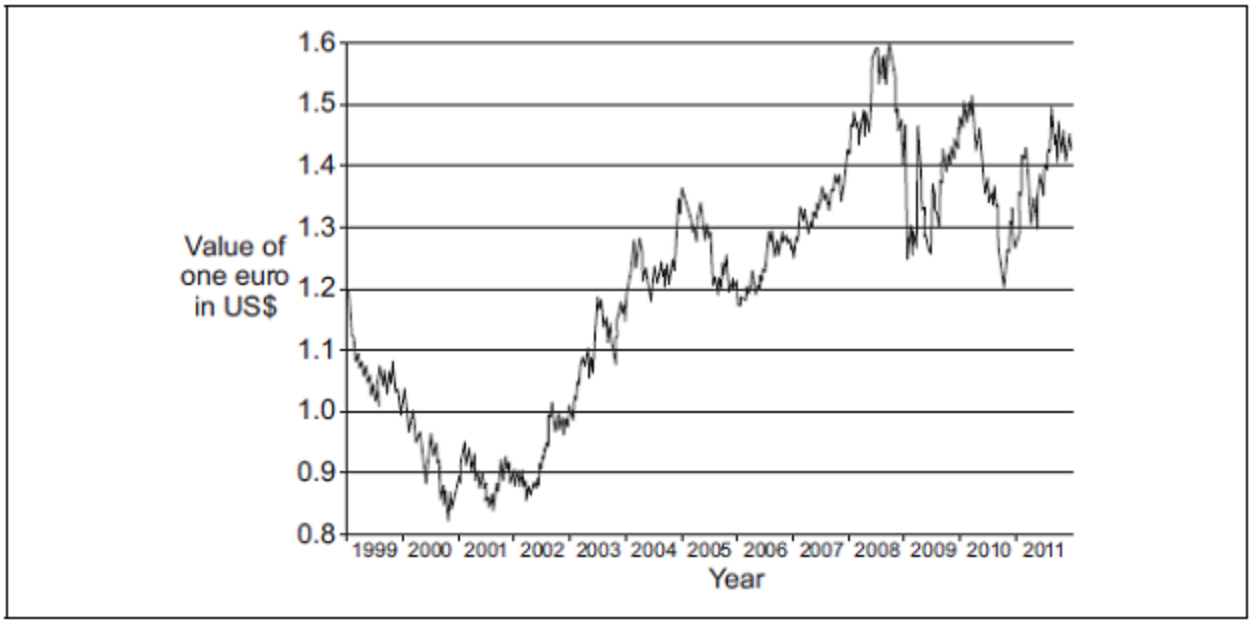
The UK might expect disruption to trade, at least in the short term, with consequences for the balance of payments. Another banking crisis could also emerge. International money, seeking a safe haven, might favour the pound sterling and thus strengthen its external value. These potential developments have implications for UK growth and employment and pose yet another threat to the current recovery. The UK might be relieved to be outside the eurozone. However, the UK is certainly not immune from the possible consequences of its break-up.

Source: European Central Bank, 2012

5.

THE EUROPEAN UNION CONTEXT

Extract C: The US$/euro exchange rate, 1999 to 2011



Source: European Central Bank, 2012

6.

'When the exchange rate of a country's currency causes problems, it may be down to free market orces, but government intervention might be to blame.'

Assess the importance of a floating exchange rate to a country trying to achieve macroeconomic stability.

[25 marks]

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7. The table below shows the effective exchange rate index for Country X in 2010 and 2012 (2012 = 100).

Year	Effective exchange rate index
2010	125
2012	100

All other things being equal, which one of the following options provides both the correct percentage change in the index from 2010 to 2012 and a valid reason why this change may have occurred?

	Change in exchange rate	Reason	
A	20%	An increase in interest rates in Country X	⬭
B	20%	An increase in interest rates in other countries	⬭
C	25%	An increase in interest rate in Country X	⬭
D	25%	An increase in interest rates in other countries	⬭

[1 mark]

8. **The European Union Context Extract E** (lines 20−22) states: '…it becomes very difficult to further stimulate domestic demand as real interest rates approach zero. On the other hand, low interest rates contributed to the Swedish currency, the Krona, falling sharply in value...'.

Explain the term 'real interest rates' **and** analyse why low interest rates may lead to a fall in the value of a currency on the foreign exchange market.

[9 marks]

9. Globalisation and outsourcing of manufacturing provides several potential benefits to economies. However, some countries, such as the UK, continue to suffer persistent trade deficits but are unable to resort to import controls.

Explain how the UK Government could reduce a balance of payments deficit on the current account, other than through the use of import controls.

[15 marks]

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10. Although international trade has benefited UK consumers greatly over the last century, improvements in transport mean it is becoming more difficult for UK firms to compete against low-cost foreign producers.

Discuss the view that protectionist policies should be introduced to protect UK firms.

[25 marks]

11. **THE EUROPEAN UNION CONTEXT**

Extract E: Sweden's economic fortunes

Only a few years ago, the Riksbank (the central bank of Sweden) was the envy of the world. The Swedish economy was a star performer early in the global recovery following the 2008 economic crisis. Sweden's economy grew three times faster than the Eurozone's in 2010. Even better, the Riksbank felt confident enough in recovery to start raising interest rates. Its main interest rate reached 2% by July 2011, while rates in most other rich economies stayed nearer to zero.

However, some economists argue that, from the beginning, Sweden's interest rate increases looked premature. When the first rate increase came, unemployment stood at 8.2%, while the inflation rate was 1.1%, well below the central bank's target. Concerns about financial stability influenced the decision to maintain higher interest rates, even though economic conditions deteriorated. The Riksbank was worried that rising household borrowing and soaring house prices could lead to adverse consequences in the long run. Yet the strategy did not go as planned and no doubt contributed to deflation in 2013.

Unemployment in Sweden has remained high and private sector debt as a share of GDP is higher now than it was in 2010 but, at the same time, house prices have continued to climb. In October 2014, the Riksbank announced it was cutting its main interest rate to zero in an effort to stimulate the economy.

However, the effectiveness of the central bank's ability to respond to avoid deflation is a concern because it becomes very difficult to further stimulate domestic demand as real interest rates approach zero. On the other hand, low interest rates contributed to the Swedish currency, the Krona, falling sharply in value, which helped exports and provided some cushion against weak global demand and further deflation.

Source: news reports, 2014

12. Although international trade has benefited UK consumers greatly over the last century, improvements in transport mean it is becoming more difficult for UK firms to compete against low-cost foreign producers.

Explain why international trade has benefited UK consumers.

[15 marks]

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13. Many people were surprised when UK unemployment fell during 2013. The government's policy of deficit reduction was expected to prevent significant falls in unemployment and some called for the government to reverse its policy of planned cuts in expenditure.

Evaluate the view that a policy of budget deficit reduction will make it harder to reduce unemployment further.

[25 marks]

14. In May 2014, the European Central Bank (ECB) President, Mario Draghi, warned that there was a risk of deflation across economies in Europe.

Explain why deflation may occur in an economy.

[15 marks]

15. Using the data in **Economic Growth and Development in Africa Extract A**, calculate, to the nearest £, the real GDP per capita of the UK in 2012 in pounds, assuming the pound to dollar exchange rate was £1 = $1.70.

[2 marks]

16. **Economic growth and development in Africa**

Extract A: Macroeconomic indicators for UK and selected African economies, 2012

Economy	Real GDP growth (% change on previous year)	Real GDP per capita ($)	Life expectancy (years)	Rural population access to improved water source (%)
UK	0.7	36 617	82	100
Central African Republic	4.1	932	50	76
Egypt	2.2	10 686	70	99
Ethiopia	8.6	1 240	63	42
Zambia	6.7	3 678	57	49

Source: official statistics, accessed on 29 June 2014

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17. Over a period of time, the value of the pound against the US dollar changes from £1 = $2.00 to £1 = $1.50. All other things being equal, this is most likely to result in

A UK products becoming more expensive in the US. ⬭

B a downturn in the UK's economic cycle. ⬭

C a higher inflation rate in the UK. ⬭

D an increase in the UK's budget deficit. ⬭

[1 mark]

18. In 2014, the UK's contributions to the European Union (EU) budget rose by £2.7bn, making it the second largest net contributor. However, it is argued that the UK benefits much more from the trade and the job creation that EU membership brings.

Evaluate the extent to which individuals and firms in the UK benefit from membership of the EU.

[25 marks]

19. **Government policy Extract F** (lines 14−17) states 'Investment forecasts are being revised downward and on top of speculation of interest rate rises and criticism of the UK's quantitative easing programme, the outlook is not looking as good as forecasts first indicated.'

Using the data in the extracts and your economic knowledge, evaluate the effectiveness of monetary policy in achieving macroeconomic stability in the UK.

[25 marks]

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20. Government policy

Extract F: Austerity remains

The Chancellor, George Osborne, has ruled out the possibility that the UK's improving economy will lead to immediate tax cuts or spending increases when he said reducing the budget deficit would be the priority of his Autumn Statement. The Chancellor said that the UK was still borrowing too much and that any increase in tax revenues generated from faster growth would be used to reduce the budget deficit and the national debt.

The move comes as no surprise, with the Chancellor stating, "I would just remind everyone that I still sit down at the table at the G20 with one of the highest budget deficits. The UK still continues to have some very serious public finance challenges that need to be addressed."

This week, the IMF revised up its forecasts for UK growth in both 2013 and 2014, six months after its chief economist, Olivier Blanchard, warned Osborne that he might cause more damage with his austerity plan. However, Osborne responded, “We have a clear plan and we are sticking to that plan."

The Chancellor's announcement may not be good for UK firms. It is common for business investment to lead the way when emerging from recession, but not this time. Investment forecasts are being revised downward and, on top of speculation of interest rate rises and criticism of the UK's quantitative easing programme, the outlook is not as good as forecasts first indicated.

In explaining its forecast downgrades for net investment over the last three years, the Office for Budget Responsibility (OBR) cites two main factors. Firstly, problems in credit markets have made it difficult for firms to borrow to invest. This may have particularly affected small and medium-sized firms that tend to be more reliant on bank financing. This will only be made worse if interest rates rise. Secondly, the uncertainty generated by the eurozone crisis and other events has stifled investment.

Source: News reports, 2013

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