

Exchange rates

A2

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What you need to know

At AS you met floating exchange rates: how demand and supply set them and what makes them rise or fall. This A Level topic adds how exchange rates are measured, how fixed and managed rates are set and held, and how a change in the rate affects the external economy. You need to be able to:

1. **Tell nominal and real exchange rates apart.** The nominal rate is the one quoted in the market; the real rate adjusts it for the difference between price levels at home and abroad, so it measures price competitiveness.
2. **Explain a trade-weighted exchange rate:** one index of the currency's value against a basket of partner currencies, each weighted by its share of the country's trade.
3. **Explain how the rate is determined under a fixed system and under a managed system**, including how the central bank holds the rate (buying and selling currency with its reserves, changing interest rates).
4. **Distinguish a revaluation from a devaluation** of a fixed rate, and both from an appreciation or depreciation of a floating or managed rate.
5. **Explain how the exchange rate changes under each system:** market forces under floating, a government decision under fixed, and a mix of the two under managed.
6. **Analyse the effects of a change in the exchange rate on the external economy** (export and import prices, the current account and, through it, the rest of the economy) using the **Marshall–Lerner condition** and the **J-curve**.

Understand it

Nominal exchange rates

An exchange rate is the price of one currency counted in another. If one unit of the home currency buys \$0.50, then \$1 buys 2 units: the same rate seen from each side. A rise in the rate means the home currency buys more foreign currency, so it is **stronger**; a fall means it is **weaker**.

This quoted market price is the **nominal** exchange rate. On its own it says nothing about whether home goods are cheap or dear abroad, because prices inside each country also change.

Real exchange rates

The **real exchange rate** corrects the nominal rate for inflation at home and abroad:

$$\text{real exchange rate} = \text{nominal exchange rate} \times \frac{\text{home price index}}{\text{foreign price index}}.$$

Suppose the nominal rate stays at \$0.50 for a year, while prices rise 9% at home and 3% abroad. Home goods now cost relatively more in foreign markets. As an index starting at 100, the real rate becomes $100 \times \frac{1.09}{1.03} = 105.8$: a **real appreciation** of about 5.8%, even though the nominal rate did not move. Exporters lose price competitiveness exactly as if the currency had risen.

So a **rise in the real rate** means home goods have become dearer compared with foreign goods (less competitive); a **fall** means they have become cheaper (more competitive). A currency whose real value is well above the level that would make the same basket of goods cost the same in both countries (purchasing power parity) is **overvalued**; one well below it is **undervalued**.

Trade-weighted exchange rates

A currency can rise against one partner and fall against another on the same day. A **trade-weighted exchange rate** (also called the effective exchange rate) combines the bilateral rates into one index, giving each partner's currency a weight equal to its share of the country's trade:

$$\% \text{ change in trade-weighted rate} = \sum (\text{trade weight} \times \% \text{ change against that currency}).$$

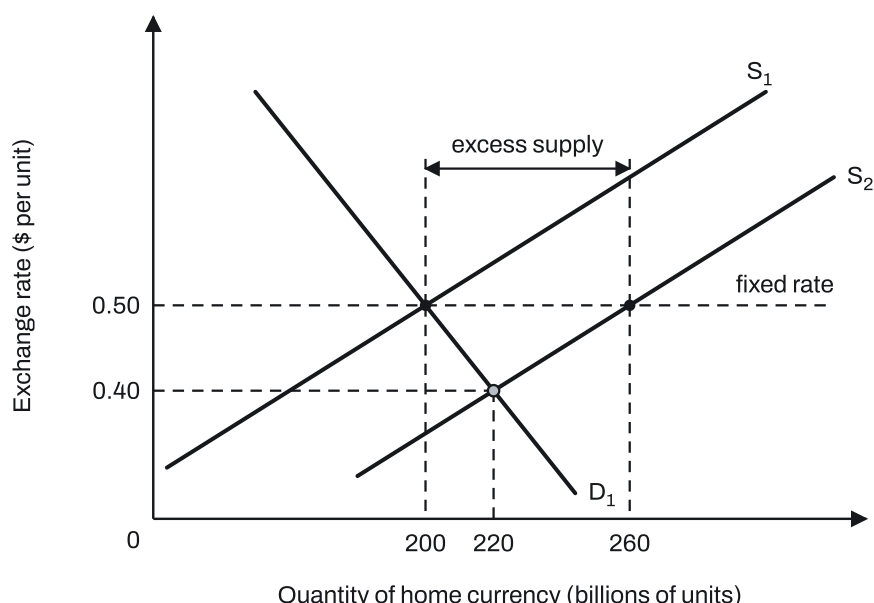
A country does 50% of its trade with partner A, 30% with B and 20% with C. Over a year its currency rises 4% against A's, falls 2% against B's and falls 10% against C's. The trade-weighted rate changes by $0.5 \times 4 + 0.3 \times (-2) + 0.2 \times (-10) = -0.6\%$, so the index falls from 100 to 99.4. A simple average of the three changes would give -2.7% , which overstates the fall because it treats small partners like big ones.

Exchange rate systems

System	Who sets the rate	How it changes	Words for a fall / a rise
Floating	Demand for and supply of the currency on the foreign exchange market; no intervention	Every day, as demand or supply shifts	Depreciation / appreciation
Fixed (pegged)	The government or central bank picks a value against another currency, a basket or gold, and holds it	Only by an official decision	Devaluation / revaluation
Managed (managed float)	The market, within limits the central bank sets; the bank steps in to keep the rate inside a band or to smooth sharp moves	Within the band by market forces; the band itself can be moved, sometimes step by step (a crawling band)	Depreciation / appreciation within the band; devaluation / revaluation if the official band is moved

Under a floating rate, demand for the currency comes from foreigners buying the country's exports, assets and holidays, and from money attracted by higher interest rates; supply comes from residents buying imports and foreign assets. Anything that cuts demand or raises supply makes it **depreciate**: more imports, fewer exports, lower interest rates, **higher inflation at home** (exports become less competitive), or speculation against it.

Holding a fixed rate



In the diagram the central bank has fixed the home currency at \$0.50, where demand D_1 and supply S_1 first meet at 200 billion units. Then spending on imports rises: residents sell more home currency to buy foreign currency, so supply shifts right to S_2 . Left alone, the rate would fall to \$0.40. To hold \$0.50 the central bank has three tools:

- **Buy its own currency with its reserves.** At \$0.50 there is an excess supply of $260 - 200 = 60$ billion units. Buying them costs $60 \times 0.50 = 30$, that is \$30 billion, of foreign currency reserves. This works only while the reserves last.
- **Raise interest rates.** Higher returns attract money from abroad, so demand for the currency rises. If demand shifts right by 60 billion units, to D_2 , it meets S_2 at \$0.50 with no reserves spent. The cost is slower spending, output and jobs at home.
- **Limit the supply of the currency**, for example with exchange controls or limits on imports.

If the pressure is the other way (a current account surplus or capital inflows), the currency is in excess **demand** at the fixed rate. The central bank then **sells** its own currency and buys foreign currency (reserves pile up), or **lowers interest rates** and expands the money supply, which sends money abroad and raises spending on imports. Selling newly created home currency adds to the money supply, which can bring inflation. That is the main drawback of holding a rate below its market level for long.

The same tools work under a managed float, but only when the rate reaches the edge of its band, or to slow a sharp move.

Price effects of a change in the exchange rate

When the home currency falls (a depreciation or devaluation):

- **exports become cheaper abroad:** a good priced at 100 units at home now costs foreign buyers fewer dollars;
- **imports become dearer at home:** a good priced at \$100 abroad now costs more home currency.

A rise does the opposite: exports dearer abroad, imports cheaper at home. Both prices move **in the home currency** too if the country's exports use imported materials: the dearer materials raise the home-currency price of the finished exports.

The fall also **worsens the terms of trade** (export prices compared with import prices), because each unit of exports now buys fewer imports. The terms of trade are not the same as the trade balance: a depreciation worsens the terms of trade straight away, but whether the trade balance improves depends on the elasticities below.

The Marshall–Lerner condition

A fall in the exchange rate changes **prices** first and **quantities** second. Whether the current account improves depends on how strongly quantities respond. The rule is the **Marshall–Lerner condition**:

A fall in the exchange rate improves the current account only if the price elasticity of demand for exports plus the price elasticity of demand for imports (ignoring minus signs) is **greater than 1**.

Why 1? Take a country whose exports and imports are each worth 200 million in its own currency. A depreciation makes its exports 10% cheaper abroad and its imports 10% dearer at home. Export prices in home currency do not change, so export revenue changes only by the change in quantity. Import spending in home currency changes by the price rise **and** the fall in quantity.

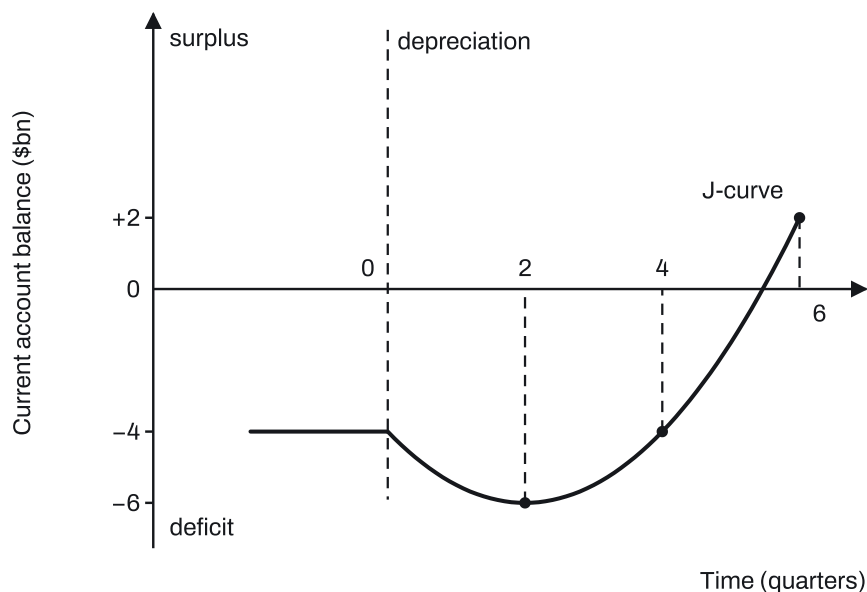
	Elasticities (exports, imports)	Export revenue	Import spending	Current account
Elastic (sum 1.4)	0.8, 0.6	$200 \times 1.08 = 216$	$200 \times 1.10 \times 0.94 = 206.8$	+9.2 million
Inelastic (sum 0.3)	0.2, 0.1	$200 \times 1.02 = 204$	$200 \times 1.10 \times 0.99 = 217.8$	−13.8 million

When demand is elastic, the extra export sales and the drop in import volume outweigh the higher price of each import, so the balance improves. When demand is inelastic, buyers at home keep buying almost the same imports at the higher price, and foreigners buy only a few more exports, so the balance **worsens**.

The condition works both ways. For a **rise** in the exchange rate (appreciation or revaluation), the current account **worsens** if the sum is more than 1, and **improves** if it is less than 1.

Two more conditions sit behind it: firms at home must have **spare capacity** to supply the extra exports (elastic supply), and other countries must not respond with their own devaluations or tariffs.

The J-curve



Elasticities are low just after a change in the exchange rate and higher later:

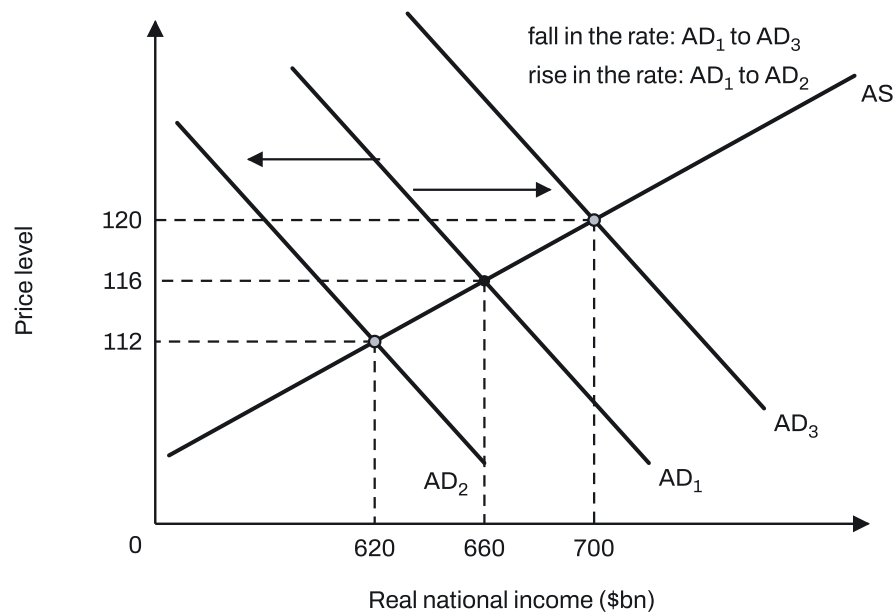
- contracts for imports and exports were signed at the old prices;
- buyers take time to notice the new prices and to find new suppliers;
- firms take time to expand output for the new export orders.

So in the **short run** the Marshall–Lerner condition usually fails and in the **long run** it holds. After a depreciation the current account first **gets worse**, then improves and ends up better than before: the shape of a J. In the diagram the deficit of \$4 billion widens to \$6 billion after two quarters, returns to \$4 billion after four, and turns into a surplus of \$2 billion after six.

After a **revaluation** or appreciation the path is the J turned upside down: the current account first **improves** (inelastic short-run demand), then worsens once the long-run elasticities exceed 1.

Effects on the rest of the economy

Net exports ($X - M$) are part of aggregate demand, so a change in the exchange rate that changes $X - M$ shifts AD.



With the Marshall–Lerner condition holding:

- a **fall** in the exchange rate raises net exports, an injection, so AD shifts right (AD_1 to AD_3): national income rises from 660 to 700, through the multiplier, and the price level from 116 to 120;
- a **rise** in the exchange rate lowers net exports, so AD shifts left (AD_1 to AD_2): national income falls to 620 and the price level to 112.

How large these effects are depends on how **open** the economy is: where exports and imports are a large share of GDP, a change in the exchange rate moves national income much more than in a fairly closed economy. The full effect also needs the long run, after the J-curve. Some effects come through costs rather than demand: dearer imported fuel and materials after a fall raise firms' costs and can shift AS left.

Key facts and formulas

There is no formula list in the 9708 exam, so everything here is "Learn it".

Formula	Status
Real exchange rate = nominal exchange rate $\times \frac{\text{home price index}}{\text{foreign price index}}$; a rise means home goods are less price competitive	Learn it
% change in a trade-weighted exchange rate = $\sum (\text{trade weight} \times \% \text{ change against each currency})$, with the weights adding to 1	Learn it
Reserves needed to hold a fixed rate = excess supply of the home currency at the fixed rate $\times$ the fixed rate	Learn it
Marshall–Lerner condition: a fall in the exchange rate improves the current account if PED for exports + PED for imports (ignoring signs) > 1 ; a rise then worsens it	Learn it

Formula	Status
Export revenue in home currency after a depreciation = old revenue $\times (1 + PED_X \times f)$, where f is the fall in the foreign-currency price of exports as a decimal	Learn it
Import spending in home currency after a depreciation = old spending $\times (1 + r)(1 - PED_M \times r)$, where r is the rise in the home-currency price of imports as a decimal	Learn it

How to do it

We tagged 30 questions for this topic (2021–2026; 28 different, because two Paper 3 questions were each set on two June papers): 24 Paper 3 multiple choice and 6 Paper 4 questions. For Paper 4 we count only the part about exchange rates. No question mixes types, so the counts add up to 30.

Question type	Questions
Marshall–Lerner and the J-curve	9
Effects of a change in the exchange rate on prices and macro objectives	8
Measurement, systems and terminology	5
Evaluate the effects of an exchange rate change or system (Paper 4 essay, 20 or 25 marks)	5
Holding a fixed rate, and what changes a currency's value	2
Data response: explain the effects of an over- or undervalued currency (4 marks)	1

1. Marshall–Lerner and the J-curve (9 questions)

All multiple choice.

- Add the two price elasticities** in each row, ignoring minus signs. Do it separately for the short run and the long run.
- Fall in the rate:** $\text{sum} > 1 \rightarrow$ current account improves; $\text{sum} < 1 \rightarrow$ it worsens.
- Rise in the rate:** $\text{sum} > 1 \rightarrow$ current account worsens; $\text{sum} < 1 \rightarrow$ it improves.
- Match the path:** worse then better after a fall is a J-curve (short-run sum below 1, long-run above 1); better then worse after a rise is an inverted J (the same elasticities).

Variations you will meet:

- What the J-curve shows** (9708/33/M/J/24 Q26, also set as 9708/31/M/J/24 Q26): after a devaluation the current account gets worse before it gets better. Not a statement of the Marshall–Lerner condition itself.
- Why it happens** (9708/32/M/J/23 Q28): a time lag before buyers recognise and react to the new prices. Demand is **inelastic** in the short run, not elastic.
- The Marshall–Lerner condition named in words** (9708/32/M/J/24 Q27): a devaluation moves the current account towards surplus if the combined elasticity is more than 1. Income elasticity and other countries' tariffs are distractors.

- **Pick the elasticities for a J-curve after a depreciation (9708/34/M/J/25 Q27):** the row whose short-run sum is below 1 and long-run sum above 1.
- **Pick the elasticities for the shape after a revaluation (9708/33/M/J/25 Q27, also set as 9708/31/M/J/25 Q27):** the curve rises then falls (inverted J), so short-run sum below 1, long-run above 1; only one row crosses 1.
- **A revaluation makes the surplus bigger first, then smaller and finally a deficit (9708/32/O/N/25 Q29):** short run less than 1, long run more than 1.
- **When does a devaluation raise national income most (9708/32/F/M/26 Q22):** in the **long run** (after the J-curve, when the condition holds) and in an **open** economy (trade is a large share of GDP).

2. Effects of a change in the exchange rate (8 questions)

All multiple choice. Work through the chain in order: prices of exports and imports → quantities (Marshall–Lerner) → current account → AD → output, jobs and inflation. Then check the extra condition in the question (spare capacity, inelastic imports, low-income economy).

	Fall (depreciation or devaluation)	Rise (appreciation or revaluation)
Export prices abroad	Fall	Rise
Import prices at home	Rise	Fall
Current account, if Marshall–Lerner holds	Improves (after the J-curve dip)	Worsens (after the inverted-J improvement)
Net exports and AD	Rise: AD shifts right	Fall: AD shifts left
Actual growth and jobs	Higher, if there is spare capacity	Lower: export and import-competing firms lose sales
Inflation	Higher: cost-push from dearer imports, demand-pull from more AD	Lower: cheaper imports and less AD
Potential growth	Imported machinery dearer, which can slow investment	Imported machinery cheaper, which can help investment
Debts in foreign currency	Dearer to repay	Cheaper to repay
Terms of trade	Worsen	Improve

Variations you will meet:

- **Devaluation and all four objectives (9708/32/O/N/25 Q18):** it helps only if the Marshall–Lerner condition holds **and** the economy is below full employment, so extra demand raises output rather than prices.
- **Elasticities both 0.3 after a depreciation (9708/32/O/N/25 Q22):** imported raw materials cost more and demand for them is inelastic, so **cost-push inflation rises**; the sum $0.6 < 1$, so net exports fall, AD falls and **demand-pull inflation falls**.
- **A revaluation on an AD/AS diagram (9708/31/O/N/25 Q23):** with Marshall–Lerner holding, net exports fall, so AD shifts left: the new long-run point has lower national income and a lower price level.

- **An appreciation with Marshall–Lerner holding (9708/32/O/N/23 Q24)**: imported inflation falls (cheaper imports) and unemployment rises (net exports fall).
- **Depreciation in a low-income economy (9708/34/M/J/25 Q29)**: it can reduce the current account deficit, reduce unemployment and raise growth.
- **Exports made with imported inputs (9708/32/M/J/23 Q26)**: a depreciation raises the home-currency price of imports **and** of the exports made from them.
- **When devaluation is most inflationary (9708/32/F/M/24 Q25)**: when there are no home-produced substitutes for imported raw materials, so firms must pay the higher price.
- **A fixed rate set well below its purchasing power parity value is allowed to float (9708/32/M/J/25 Q26)**: it will rise, imports become cheaper, and the aim that gains most is **low inflation**.

3. Measurement, systems and terminology (5 questions)

All multiple choice. Learn the table in "Understand it".

- **A central bank lowers the official value (9708/33/O/N/25 Q25)**: devaluation.
- **Floating falls and fixed rises (9708/32/O/N/24 Q27)**: depreciation and revaluation.
- **A trade-weighted rate (9708/32/O/N/25 Q25)**: the price of a currency against a basket of currencies.
- **Held within a narrow band that itself moves (9708/32/F/M/24 Q28)**: a managed float.
- **Why floating could help a country with a persistent deficit inside a fixed system (9708/31/O/N/25 Q30)**: its currency could depreciate and make exports more competitive. A floating rate does not make the rate less volatile or balance trade automatically.

4. Evaluate the effects of an exchange rate change or system (5 questions)

Paper 4 essays. Since 2023 they are worth 20 marks: **Table A** (knowledge, understanding and analysis, 14 marks; Level 3 is 11–14) and **Table B** (evaluation, 6 marks; Level 2 is 4–6). So far: the effect of a **rise** in the exchange rate on the macroeconomic aims (9708/41/O/N/25 Q4), the effect of a **fall** on the same aims (9708/42/O/N/25 Q4), and how far a depreciation helps a low-income country grow (9708/42/M/J/23 Q4). Before 2023 they were worth 25 marks, marked in four levels (Level 4 is 18–25 and needs analysis, at least one evaluative comment and a conclusion): moving from a fixed to a floating rate (9708/43/O/N/22 Q7) and whether to borrow from the IMF on condition of a devaluation (9708/43/O/N/21 Q7).

Answer plan for "Evaluate the effect of a rise (or fall) in the exchange rate on the macroeconomic aims"

1. **Define (AO1)**: the exchange rate (price of one currency in another), appreciation/depreciation or revaluation/devaluation, and the aims you will use (economic growth, low unemployment, low and stable inflation, a sustainable current account).
2. **Price effects (AO2)**: what happens to export prices abroad and import prices at home, and so to the quantities demanded.
3. **The current account**: link the quantities to $X - M$ through the Marshall–Lerner condition; mention the J-curve (or the inverted J for a rise).

4. **AD and the diagram:** $X - M$ is an injection, so AD shifts (right for a fall, left for a rise). Draw the **AD/AS diagram** with labelled axes (price level, real national income), both AD curves and both equilibria, and refer to it in the text. The mark schemes also accept the multiplier or the 45° diagram for this step. A currency diagram can show **why** the rate changed, but it is an extra: it does not replace AD/AS.
5. **At least two aims, each developed:** the mark schemes ask for a minimum of two developed aims for Level 3. For growth, say whether it is **actual** growth (more AD, using spare capacity) or **potential** growth (investment, the cost of imported capital goods). For unemployment and inflation, show the trade-off: a fall helps jobs but adds to inflation; a rise does the reverse.
6. **Evaluate (AO3)** with developed points:
 - **why the rate changed:** a rise caused by an export boom or by FDI comes with more output, while one caused by high interest rates comes with weaker spending;
 - **elasticities:** the Marshall–Lerner condition and the J-curve; many low-income countries export primary goods whose demand is price inelastic;
 - **supply capacity:** after a fall, output can rise only if firms have spare capacity; farm exports are slow to respond (price inelastic supply), oil exports can respond faster;
 - **the Phillips curve:** in the short run lower unemployment comes with higher inflation, so a fall helps one aim and harms the other;
 - **openness and the multiplier:** the share of $X - M$ (and of trade) in GDP, and the size of the marginal propensity to import, decide how far AD moves;
 - **foreign-currency debt:** a fall makes debts in dollars dearer to repay, a rise makes them cheaper; debts in the home currency are not affected this way;
 - **capital flows:** a fall makes the country's assets cheaper for foreign firms and can attract FDI and multinationals, adding output and jobs; a rise makes FDI dearer;
 - **a reserve currency** such as the US dollar stays in demand even when it rises, and much world trade is priced in it, so a rise hurts its exports less than the simple story suggests.
7. **Conclude** on the question's words: which aims gain, which lose, in the short run and the long run, and what decides the overall effect.

Variations you will meet:

- **"How far a depreciation helps a low-income country grow" (9708/42/M/J/23 Q4):** the same chain, applied to a **low-income** country: primary exports with inelastic demand and supply, imported capital goods and fuel that become dearer, debts in dollars. Ending the chain at growth (actual and potential) and keeping the low-income setting in every paragraph is what lifts it.
- **"Moving from a fixed to a floating rate will cut unemployment in the short run but raise inflation in the long run" (9708/43/O/N/22 Q7):** explain how each system sets the rate. Under a fixed rate, cutting interest rates to create jobs pushes the currency down, so the central bank must buy it with reserves or put rates back up, undoing the policy. Once the rate floats, lower interest rates bring a depreciation that adds export demand to the extra spending at home, so jobs grow faster, though mainly **cyclical** unemployment falls, not structural. In the long run the lower currency raises import costs (cost-push inflation), and the central bank loses the discipline the peg gave it, so inflation can rise; but global commodity prices and the size of the output gap matter too. Test **both** halves of the statement.

- **IMF loans conditional on a devaluation (9708/43/O/N/21 Q7)**: take each condition in turn. The devaluation can improve the current account if Marshall–Lerner holds, but brings cost-push inflation and makes the country's dollar debts dearer; set this against the benefit of the loan.

5. Holding a fixed rate, and what changes a currency's value (2 questions)

All multiple choice.

1. Decide the direction of pressure. A deficit, capital outflows or high inflation push the currency **down**; a surplus or capital inflows push it **up**.
2. To hold a fixed rate under **downward** pressure: buy the home currency with reserves, raise interest rates. Under **upward** pressure: sell the home currency (reserves rise), cut interest rates, expand the money supply.

Variations you will meet:

- **A fixed rate with a current account surplus (9708/34/O/N/25 Q29)**: the pressure is upwards, so the desirable policy is expansionary monetary policy. Selling foreign currency would push the rate further up; export subsidies and import barriers would make the surplus bigger.
- **Which change would not raise the currency's value (9708/32/F/M/25 Q23)**: higher domestic inflation, because exports become less competitive. Higher interest rates, higher incomes abroad and more tourists all raise demand for the currency.

6. Data response: explain the effects of an over- or undervalued currency (1 question)

One 4-mark part so far: how an **overvalued** exchange rate may affect an economy, with an extract about an oil-rich country (9708/42/O/N/22 Q1 (c)).

1. **Price effects (up to 2 marks)**: export prices rise abroad, so fewer exports are sold (1); import prices fall at home, so more imports are bought (1).
2. **Development (up to 2 marks)**: carry the effect to one or two of the current account, inflation, unemployment, growth or FDI, and use the extract where you can.

Worked examples

Example 1

A country's trade is 60% with country X, 25% with country Y and 15% with country Z. Over a year its currency rises by 5% against X's currency, falls by 4% against Y's and falls by 12% against Z's. What happens to its trade-weighted exchange rate?

- **A** It falls by about 3.7%.
- **B** It falls by 0.2%.
- **C** It rises by 0.2%.

- **D** It rises by 5%.

[1]

Weight each change by the trade share: $0.6 \times 5 + 0.25 \times (-4) + 0.15 \times (-12) = 3 - 1 - 1.8 = +0.2\%$.
The answer is **C** (1). A is the simple average of the three changes, which ignores the weights.

Example 2

A country with a fixed exchange rate has a large current account surplus and revalues its currency. Which estimates mean that the surplus becomes smaller straight away and keeps getting smaller?

	Short-run PED for exports	Short-run PED for imports	Long-run PED for exports	Long-run PED for imports
A	0.3	0.4	0.7	0.6
B	0.6	0.5	0.9	0.8
C	0.2	0.2	0.3	0.4
D	0.7	0.6	0.4	0.3

[1]

After a rise, the current account worsens (the surplus shrinks) when the sum of the elasticities is more than 1. Short-run sums: A 0.7, B 1.1, C 0.4, D 1.3. Long-run sums: A 1.3, B 1.7, C 0.7, D 0.7. Only B is above 1 in both. (A gives the inverted J: the surplus grows first. D shrinks then grows again. C keeps growing.) The answer is **B** (1).

Example 3

Extract: Country R kept its currency within a narrow band against the US dollar. Over six months its central bank sold \$6 billion of its reserves to support the currency. In March the government cut the central rate of the band by 12%. R imports most of its fuel and machinery.

(a) Explain the difference between a devaluation and a depreciation. [2]

(b) Explain how the change in March may affect inflation in R. [4]

(a) A devaluation is a decision by the government or central bank to lower the official (fixed or central) value of the currency (1). A depreciation is a fall in the currency's value caused by market forces, a change in demand for or supply of the currency, under a floating or managed system (1).

(b) The devaluation makes imports dearer in R's currency (1). Since R imports most of its fuel and machinery and has few substitutes for them, firms' costs rise and they pass them on in higher prices: **cost-push inflation** (1). R's exports also become cheaper abroad, so if demand for them is price elastic enough for the Marshall–Lerner condition to hold, net exports and aggregate demand rise (1). If R is close to full capacity the extra demand pulls up prices: **demand-pull inflation** (1).

((a) 2 + (b) 4: **6/6.**)

Example 4

Evaluate whether a country with a large current account surplus and rising inflation should revalue its fixed exchange rate. [20]

Model answer (paragraph plan):

1. **Terms.** An exchange rate is the price of one currency in terms of another. Under a fixed system the central bank sets the value and holds it by buying and selling its currency; a **revaluation** is an official decision to raise that value. A current account surplus means the country receives more from exports, income and transfers than it pays out. With a surplus, demand for the currency exceeds supply at the fixed rate, so the central bank must keep selling its own currency to hold the peg. (AO1: *accurate knowledge.*)
2. **The case for revaluing: the external economy.** After a revaluation exports become dearer abroad and imports cheaper at home. If the price elasticities of demand for exports and imports add to more than 1 (Marshall–Lerner), export revenue falls and import spending rises, so the surplus shrinks towards balance. (AO2: *developed chain from prices to quantities to the current account.*)
3. **The case for revaluing: inflation.** Cheaper imported fuel, food and materials lower firms' costs, reducing cost-push inflation. Lower net exports reduce AD: on the AD/AS diagram AD shifts left from AD_1 to AD_2 , and the price level falls from 116 to 112, reducing demand-pull inflation. The central bank also stops creating new currency to sell, so growth of the money supply slows. (AO2: *two routes to lower inflation, with the diagram explained.*)
4. **The case against: growth and jobs.** The same leftward shift of AD lowers real national income from 660 to 620 through the multiplier. Exporters and firms competing with imports lose sales and cut jobs, so unemployment rises and actual growth slows. Investors may also find the country's assets dearer, so FDI can fall. (AO2: *the costs analysed on the same diagram. Two aims each developed on both sides: Table A Level 3, here 14/14.*)
5. **The alternative: keep the peg.** If the government does not revalue, the central bank goes on selling its currency and buying foreign currency. Reserves pile up, and the extra home currency adds to the money supply and to inflation. Cutting interest rates to discourage inflows would add to inflation as well. So holding the peg works against the inflation aim. (AO3: *the other side weighed.*)
6. **Evaluation 1: elasticities and time.** Just after the revaluation demand is inelastic, because contracts are fixed and buyers take time to switch, so the surplus may first **grow** (an inverted J) before it shrinks. If the long-run elasticities stay below 1, as for many primary exports, the surplus does not shrink at all, although the inflation benefit from cheaper imports still comes. (AO3: *developed, reasoned comment.*)
7. **Evaluation 2: the state of the economy.** With rising inflation the economy is probably close to full capacity, so a fall in AD mainly lowers prices and costs fewer jobs than it would in a slump. How much AD falls depends on how open the economy is and on its marginal propensity to import. A revaluation also makes debts in foreign currency cheaper to repay and imported machinery cheaper, which can help potential growth. (AO3: *developed, reasoned comment.*)

8. **Conclusion.** A revaluation suits this country: it attacks inflation through import prices, AD and the money supply, and it should shrink the surplus in the long run, at the cost of slower growth and some job losses. The case is strongest when the economy is near full capacity and demand for exports is price elastic; a moderate revaluation, perhaps in steps, limits the job losses. (AO3: *justified conclusion on "should". Table B Level 2, here 6/6.*)

(Table A: 14; Table B: 6; **20/20.**)

Common mistakes

- **Labelling the currency diagram's vertical axis "P" or "Price".** AS reports (Paper 21 in November 2021, November 2022 and June 2023) found this again and again. Label it "exchange rate" or "price of the currency in US dollars", and the horizontal axis "quantity of the currency".
- **Forgetting that a fixed rate is set by the authorities.** The June 2022 AS report (Paper 21 Q4(a)) found answers that described fixed rates without saying the government or central bank sets them, rather than the market.
- **Not linking a deficit to pressure on the rate.** The November 2021 AS report (Paper 21 Q4(a)) found few answers saying that a current account deficit pushes the currency down, which is why the central bank must act.
- **Naming Marshall–Lerner without explaining it.** The June 2022 AS report (Paper 22) found answers that wrote "Marshall–Lerner" or "the current account will improve" with no reason. Say what the condition is, and what elastic or inelastic demand does to export revenue and import spending.
- **Drawing the wrong diagram in a macro essay.** In March 2025 (Paper 42 Q4, on policies to control inflation) weaker answers drew micro diagrams where an AD/AS diagram was required, which held them back; the question asked for a diagram, and a correct one was needed for Level 3. For any essay on the effects of an exchange rate change, the AD/AS diagram is the one to draw.
- **One-line evaluation.** The same March 2025 report found brief one-sentence evaluation kept many answers at Level 1 for AO3, while answers that used the Marshall–Lerner condition with the inverted J-curve when evaluating a revaluation (Q4), or the J-curve when evaluating a devaluation (Q5), earned high evaluation marks. Explain the time path, don't just name it.
- **Answering only part of the question.** In June 2023 (Paper 42 Q4) weaker answers explained the depreciation but ignored the low-income setting and the evaluation. In November 2022 (Paper 43 Q7) the few answers on fixed and floating rates were general and did not deal with the statement. Every paragraph should come back to the exact words: "aims", "low-income", "short run", "long run".
- **Stopping at prices.** The November 2022 report (Paper 42 Q1(c)) found the best answers went beyond relative prices and demand to the balance of payments and to AD and unemployment.
- **Mixing up the terms of trade and the trade balance.** The November 2022 AS report (Paper 23 Q4(a)) found answers using elasticities, Marshall–Lerner and the J-curve to explain the terms of trade. These decide the trade balance; a fall in the exchange rate worsens the terms of trade whatever the elasticities.
- **Using the wrong word for the system.** Devaluation and revaluation are official changes to a fixed rate; depreciation and appreciation are market movements.

How to get the marks

- **Multiple choice:** for an elasticity table, add the two elasticities in each period and compare with 1, remembering that the rule flips for a rise. For terminology, ask "market or official decision?" and "up or down?". For effects, follow the chain prices → quantities → current account → AD, and check for spare capacity.
- **Data response "explain" (4 marks):** two price effects with their effect on quantities (up to 2 marks), then develop one or two of them into the balance of payments, inflation, jobs or growth (up to 2), using the extract.
- **20-mark essays:** Table A (14) rewards accurate definitions, a full chain from the exchange rate to $X - M$ to AD, an explained AD/AS diagram, and **at least two aims** analysed; Table B (6) rewards developed evaluation (Level 2 is 4–6) and a justified conclusion. One-line evaluation stays in Level 1 (1–3).
- **25-mark essays** (pre-2023 papers): Level 4 (18–25) needs analysis of each part of the statement, at least one evaluative comment and a conclusion.
- **"Evaluate the effect":** show which aims gain **and** which lose; a fall helps growth, jobs and (if Marshall–Lerner holds) the current account but harms inflation, and a rise does the opposite.
- **"Evaluate this statement":** test each part ("in the short run", "in the long run", "will solve") separately.
- **"Consider the extent to which":** decide how far, and on what it depends (elasticities, spare capacity, openness, debt, cause of the change).
- **Use the J-curve with its time path:** what happens in the first months, and why it changes later.

Quick check

1. Name each change: (a) the government announces that its currency's pegged value against the euro is cut by 8%; (b) a floating currency falls after the central bank cuts interest rates; (c) a currency in a managed band rises to the top of the band; (d) a central bank raises the official value of its pegged currency.
2. Over a year a country's nominal exchange rate falls by 2%. Prices rise by 6% at home and by 1% abroad. Calculate the percentage change in its real exchange rate, and say whether its exports have become more or less price competitive.
3. A country's exports and imports are each worth 300 million in its own currency. Its currency appreciates, making its exports 5% dearer abroad and its imports 5% cheaper at home. The PED for exports is 0.4 and for imports 0.3. Calculate the new export revenue, the new import spending and the change in the current account, and explain the result.
4. A central bank holds its currency at a fixed rate of \$2.00. At that rate, demand for the currency is 75 billion units and supply is 60 billion units. Calculate the change in the central bank's foreign currency reserves needed to hold the rate, and explain why holding it may cause inflation.
5. A low-income country's main export is coffee. Demand for its coffee is price inelastic, and new coffee bushes take several years to bear fruit. Its currency depreciates by 15%. Explain two reasons why its economic growth may rise only a little. [4]

Answers

1. (a) Devaluation. (b) Depreciation. (c) Appreciation. (d) Revaluation.
2. Real rate index $= 100 \times 0.98 \times \frac{1.06}{1.01} = 102.9$, a real **rise** of about 2.9%. Although the nominal rate fell, home prices rose much faster than foreign prices, so exports are **less** price competitive.
3. Export revenue (home-currency prices unchanged, quantity falls by $0.4 \times 5 = 2\%$): $300 \times 0.98 = 294$ million. Import spending (price -5% , quantity $+0.3 \times 5 = 1.5\%$): $300 \times 0.95 \times 1.015 = 289.275$ million. The current account changes by $294 - 289.275 = +4.725$ million, an **improvement**. The elasticities add to $0.7 < 1$, so demand is too inelastic for the rise to cut exports or raise imports by much; the cheaper price of each import dominates. This is the first part of an inverted J.
4. At \$2.00 there is excess demand of $75 - 60 = 15$ billion units. The central bank must **sell** 15 billion units of its own currency and buy foreign currency, so its reserves **rise** by $15 \times 2 = 30$, that is \$30 billion. The home currency it sells is new money, so the money supply rises; more spending can then pull up prices (demand-pull inflation).
5. Demand for coffee is price inelastic, so cheaper coffee abroad sells only a little more and export revenue hardly rises (1); if the elasticities of demand for exports and imports add to less than 1, net exports even fall, so AD does not rise and there is little extra output (1). Supply of coffee is also price inelastic, because new bushes take years to bear fruit (1), so any extra demand raises prices rather than output, and actual growth stays low (1). (Another reason worth 1 + 1: imported machinery and fuel become dearer, which holds back investment and potential growth.)

Past questions to try

- 9708/34/M/J/25 Q27: pick the elasticities that give a J-curve.
- 9708/32/F/M/24 Q28: name the system with a moving band.
- 9708/42/M/J/23 Q4: how far a depreciation helps a low-income country grow.
- 9708/43/O/N/22 Q7: moving from a fixed to a floating rate, unemployment and inflation.