

Exchange rates

AS

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What you need to know

By the end of this topic you should be able to:

1. **Define an exchange rate:** the price of one currency measured in another currency, such as 1 zed = US\$0.50.
2. **Explain how a floating exchange rate is determined:** by the demand for and the supply of the currency on the foreign exchange market, with no target set by the government or central bank. The equilibrium rate is where the two are equal.
3. **Tell depreciation and appreciation apart:** a depreciation is a fall in the value of a floating currency against another currency; an appreciation is a rise. Both are caused by market forces.
4. **Explain the causes of a change in a floating exchange rate** as a shift in the demand for, or the supply of, the currency, and show it on a diagram.
5. **Use AD/AS analysis** to show how a change in the exchange rate affects the domestic economy's equilibrium national income, real output, price level and employment.

Fixed and managed exchange rates, devaluation and revaluation, trade-weighted and real exchange rates, and the Marshall–Lerner condition and J-curve are in the A Level part of the syllabus (topic 11.2). Older AS papers asked about some of them, so "How to do it" gives the short version you need for those questions.

Understand it

What an exchange rate is

To buy anything from another country you need its currency. The **foreign exchange market** is where one currency is swapped for another, and the **exchange rate** is the price at which the swap happens.

Every exchange rate can be written two ways. Take a made-up country whose currency is the **zed** (Z). If 1 zed buys 0.50 US dollars, then 1 dollar buys 2 zeds:

$$Z1 = \$0.50 \quad \Longleftrightarrow \quad \$1 = Z2.$$

Always check which way round the rate is written. "\$0.50 per zed" is the price of the zed. "Z2 per dollar" is the price of the dollar. If the number of zeds per dollar **rises**, each zed is worth **less**: the zed has fallen.

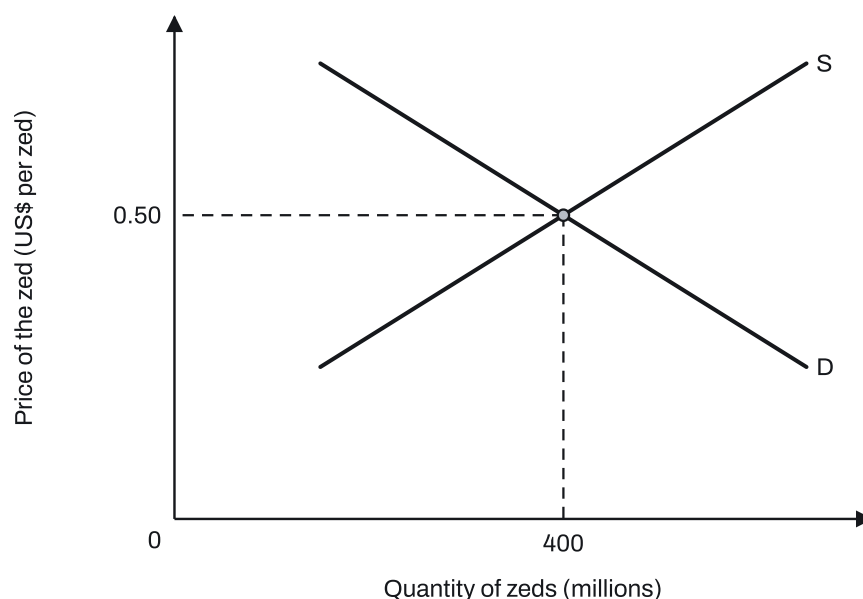
Who demands and who supplies a currency

Think about who wants to **buy** zeds (demand) and who wants to **sell** zeds to get other currencies (supply).

Demand for zeds comes from...	Supply of zeds comes from...
Foreigners buying the country's exports of goods and services (including tourists visiting it)	Residents buying imports of goods and services (including holidays abroad)
Foreign firms setting up or buying firms in the country (inward investment , FDI)	Residents investing abroad (outward investment)
Foreign savers moving money in to earn higher interest ("hot money")	Residents moving savings abroad to earn higher interest there
Speculators who expect the zed to rise	Speculators who expect the zed to fall
Income and transfers paid to residents from abroad (profits, interest, remittances)	Profits, interest and dividends paid to foreign owners; money sent abroad

Notice the link to the current account: exports and income received create demand for the currency; imports and income paid abroad create supply of it.

How a floating rate is determined



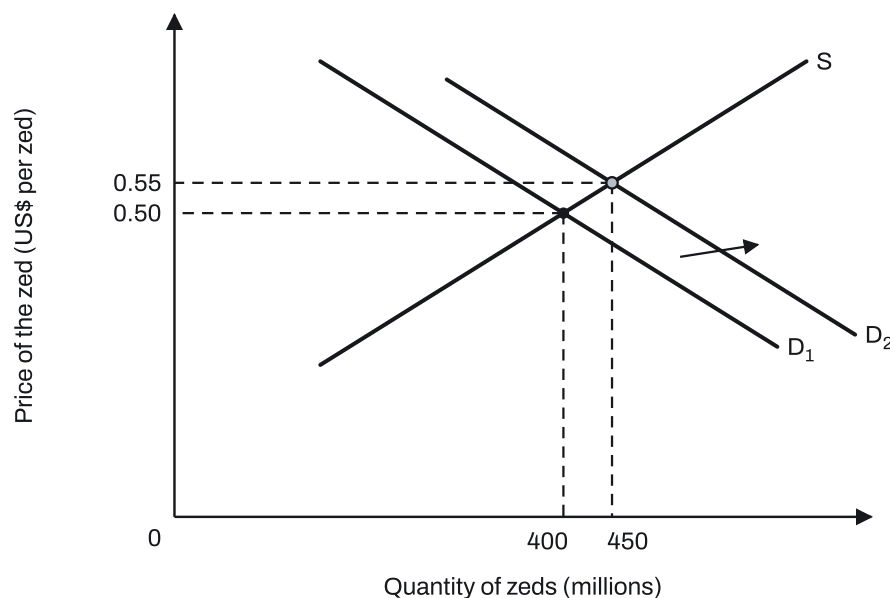
Draw it like any market, but label it carefully: the vertical axis is the **price of the currency in another currency** (here "US\$ per zed", or just "exchange rate"), and the horizontal axis is the **quantity of the currency**.

- **Demand slopes down.** When the zed is cheaper, the country's exports are cheaper for foreigners, so they buy more of them and need more zeds.

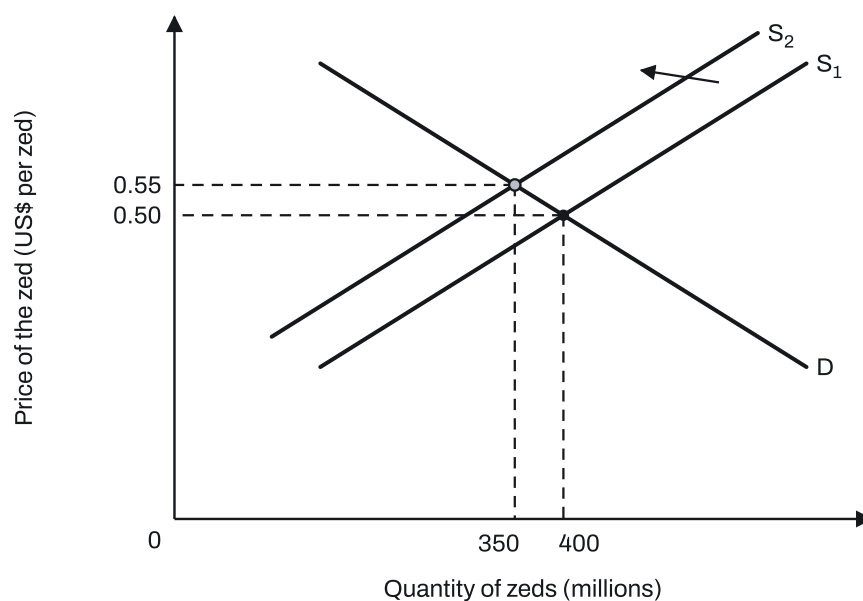
- **Supply slopes up.** When the zed is dearer, foreign goods are cheaper in zeds, so residents buy more imports and offer more zeds to get foreign currency.
- **Equilibrium** is where demand equals supply: \$0.50 per zed in the diagram. Above it there are more zeds offered than wanted and the price falls; below it there is a shortage and the price rises. Under a **floating** exchange rate nobody sets this price: it moves whenever demand or supply changes.

Appreciation: demand rises or supply falls

An **appreciation** is a rise in the value of a floating currency against other currencies. Only two shifts can cause one, and each gets its own diagram.

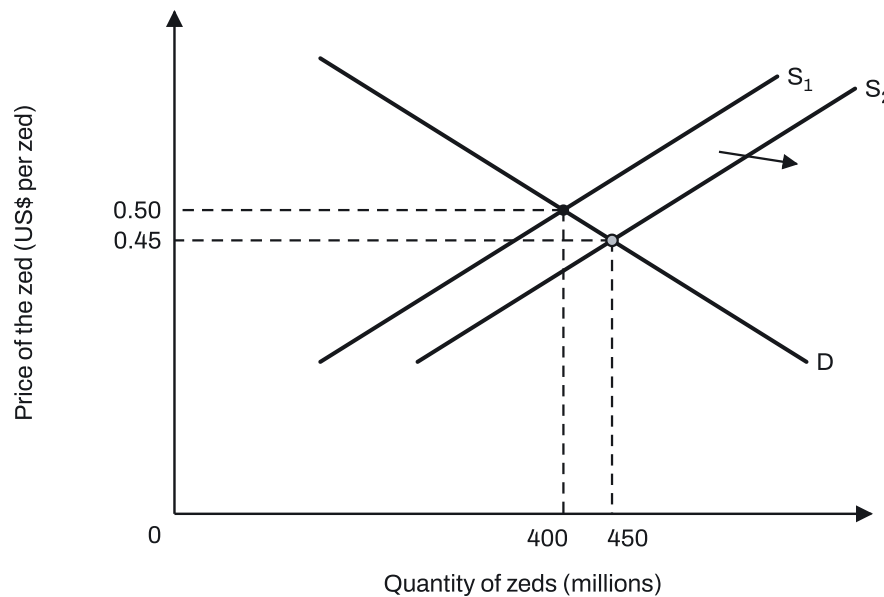


Demand for the zed rises (D₁ to D₂): for example, foreigners buy more of its exports, or foreign savers move money in. The rate rises from \$0.50 to \$0.55, a 10% appreciation, and more zeds are traded.



Supply of the zed falls (S1 to S2): for example, residents buy fewer imports, so they sell fewer zeds for dollars. The rate again rises to \$0.55, but now **fewer** zeds are traded (350 million).

Depreciation: supply rises or demand falls



A **depreciation** is a fall in the value of a floating currency. **Supply of the zed rises** (S1 to S2 above), for example because residents buy more imports, and the rate falls from \$0.50 to \$0.45, a 10% depreciation. The other cause is a **fall in demand** for the zed: draw the diagram the same way as diagram 2, but with the new demand curve D2 to the **left** of D1, so the rate falls.

When one currency depreciates, the other appreciates. At \$0.45 per zed, one dollar buys $1 \div 0.45 = 2.222$ zeds instead of 2, so the dollar has appreciated by 11.1% against the zed while the zed has depreciated by 10% against the dollar. The two percentages are not the same, because they are measured from different starting numbers.

The words **devaluation** and **revaluation** mean a fall or rise in a **fixed** exchange rate decided by the government. For a floating rate, use depreciation and appreciation.

Causes of a change in a floating rate

Every cause works through demand or supply. Ask: "Does this make people want to buy more or fewer zeds, or sell more or fewer?"

Change in the country	Effect on the market for zeds	Exchange rate
Exports rise (better quality, a boom abroad, a new resource)	Demand rises	Appreciates
Imports rise (a boom at home, tastes)	Supply rises	Depreciates

Change in the country	Effect on the market for zeds	Exchange rate
A discovered resource replaces imports	Supply falls	Appreciates
Inflation higher than trading partners'	Exports less competitive, so demand falls; imports more attractive, so supply rises	Depreciates
Interest rates higher than abroad	Hot money flows in, so demand rises (and residents keep savings at home, so supply falls)	Appreciates
More inward investment (foreign firms buying or building firms)	Demand rises	Appreciates
Speculators expect a rise	They buy now, so demand rises	Appreciates (the expectation fulfils itself)
Loss of confidence in the economy or its banks	Foreigners pull money out; residents move savings into other currencies, so demand falls and supply rises	Depreciates
Trading partners put up barriers to its exports	Demand falls	Depreciates
It puts barriers or extra paperwork on its own imports	Imports fall, so supply falls	Appreciates

- **"Relative" matters.** A high interest or inflation rate only moves the exchange rate if it is high **compared with other countries**. If every central bank raises rates together, hot money has nowhere better to go.
- **Value, not volume, of trade.** Supply of zeds depends on how many zeds residents **spend** on imports. If import prices fall and demand for imports is price elastic, spending on them rises, so supply of zeds rises (9708/14/M/J/22 Q22 works the same idea for the pound and US exports).

How much the rate moves depends on the slopes. If demand for and supply of the currency are both **price inelastic** (steep), a given shift changes the rate a lot, so the currency swings most (9708/14/M/J/22 Q25).

Effects on prices of exports and imports

A change in the exchange rate changes prices before it changes anything else. With the zed at \$0.50, a good priced at Z200 sells in the USA for \$100, and a US good priced at \$36 costs Z72 in the zed country.

	Z200 export, price in US\$	\$36 import, price in zeds
\$0.50 per zed	\$100	Z72
Depreciation to \$0.45	\$90 (cheaper abroad)	Z80 (dearer at home)
Appreciation to \$0.55	\$110 (dearer abroad)	Z65.45 (cheaper at home)

So a **depreciation** makes exports **cheaper in foreign currency** and imports **dearer in the home currency**. An **appreciation** does the opposite. The home-currency price of the export and the foreign-currency price of the import have not changed: watch for options that swap them.

What happens next depends on **price elasticity of demand (PED)**:

- If foreign demand for the exports is **price elastic**, the cheaper price raises the quantity sold by a larger percentage, so export **revenue** rises.
- If demand for imports at home is **price elastic**, the dearer price cuts the quantity bought by more, so **spending** on imports falls.
- If both are inelastic, volumes hardly change; the country pays more for the same imports, and the trade balance can get **worse**. In the **short run** demand is often inelastic (contracts are already signed, habits take time to change), so a depreciation may take months to help.

A firm can also choose not to pass the change on. A zed exporter that keeps its US price at \$30 after the zed falls from \$0.50 to \$0.40 now receives Z75 per unit instead of Z60, 25% more, so its zed revenue rises at the same dollar price (9708/12/O/N/22 Q26).

Winners and losers from a depreciation

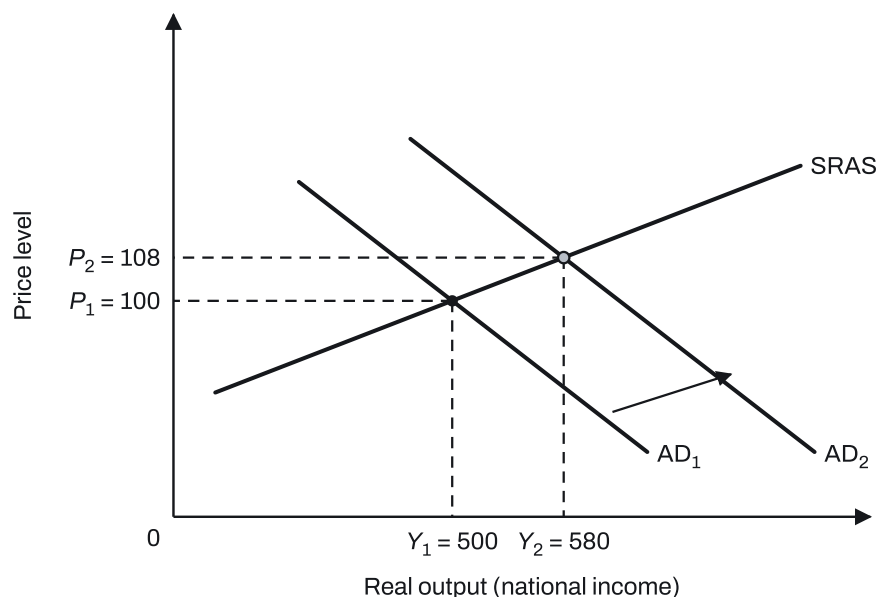
- **Gain:** exporters, most of all those selling abroad and using **domestic** inputs (9708/12/O/N/24 Q24); firms competing with imports (imports are now dearer); the tourism industry; workers in these industries.
- **Lose:** firms that rely on **imported raw materials and components** (their costs rise); consumers who buy imported goods (living standards fall); people and firms with debts in foreign currency (each dollar owed costs more zeds); residents travelling abroad.
- **Abroad:** the other country's firms lose sales in the depreciating country, and its producers face cheaper competition. When the Turkish lira falls against the Egyptian pound, Turkish buyers switch from Egyptian to Turkish-made goods: production falls in Egypt and rises in Turkey (9708/11/M/J/22 Q19).

An appreciation turns these round.

AD/AS analysis of an exchange-rate change

Net exports ($X - M$) are part of aggregate demand:

$$AD = C + I + G + (X - M).$$



A depreciation (if demand for exports and imports is elastic enough):

1. Exports rise and spending on imports falls, so net exports rise.
2. **AD shifts right** (AD₁ to AD₂). Through the multiplier, extra spending by exporters' workers adds more.
3. Equilibrium **national income and real output rise** (500 to 580 in the diagram).
4. Firms need more workers to make more output, so **employment rises** and unemployment falls.
5. The **price level rises** (100 to 108): demand-pull inflation.
6. Dearer imported raw materials, fuel and components also raise firms' costs, so **SRAS can shift left**: cost-push inflation, pushing the price level up further and taking back some of the extra output.

How the AD shift splits between **output** and **inflation** depends on **spare capacity**: with high unemployment output and jobs rise; near full employment prices mostly rise.

An appreciation is the same diagram read backwards (AD₂ to AD₁): exports dearer abroad, imports cheaper at home, net exports fall, **AD shifts left**, so real output, national income and employment fall and the price level falls. Cheaper imported inputs lower firms' costs, so SRAS can shift right, which lowers inflation further and can offset part of the fall in output.

Is the change good or bad? It depends

Every "consider" or "assess" answer weighs the same few conditions: **PED** of exports and imports (inelastic demand means volumes and AD barely move); **openness** (how big a share of AD net trade is); **imported inputs** (more of them means more cost-push inflation after a depreciation); **spare capacity** (output can rise only if resources are idle); **time** (volumes respond slowly); **why the rate changed** (an appreciation caused by an export boom comes with AD already rising); and **non-price competitiveness** (buyers of unique goods care less about price).

Key facts and formulas

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

Formula	Status
If 1 unit of A = e units of B, then 1 unit of B = $\frac{1}{e}$ units of A	Learn it
% change in a currency's value = $\frac{\text{new value} - \text{old value}}{\text{old value}} \times 100$, with the value measured in the other currency	Learn it
Price abroad = home-currency price $\times$ exchange rate (foreign currency per unit of home currency)	Learn it
Price at home = foreign-currency price $\div$ exchange rate (foreign currency per unit of home currency)	Learn it
$AD = C + I + G + (X - M)$	Learn it
Floating rate rises (appreciation) when demand for the currency rises or supply of it falls	Learn it
Floating rate falls (depreciation) when demand for the currency falls or supply of it rises	Learn it

How to do it

We tagged 59 questions for this topic (2021–2026): 42 Paper 1 multiple choice and 17 Paper 2 data-response and essay questions. For Paper 2 we count only the parts about exchange rates. 11 questions fall under more than one type (an 8-mark part that asks for causes and then effects, for example), so the counts add up to 70.

Question type	Questions
Causes of an appreciation or depreciation (demand and supply of the currency)	25
Effects of a depreciation or appreciation on the economy	21
Fixed, managed and floating systems	10
Define the terms and explain how a floating rate is set	5
Read or calculate from exchange-rate data	5
An exchange-rate change on an AD/AS diagram	4

1. Causes of an appreciation or depreciation (25 questions)

Multiple choice (16 questions):

1. **Name who is buying or selling the currency** in each option: a foreign buyer of exports, an importer, an investor, a saver, a speculator.
2. **Decide which curve moves, and which way.** Buying the currency is demand; selling it to get another currency is supply.
3. **Read off the rate:** more demand or less supply means it rises; less demand or more supply means it falls.

Variations you will meet:

- **"Most likely to cause a rise (or fall)"**: relatively higher interest rates make it rise ([9708/14/M/J/22 Q26](#), [9708/12/F/M/23 Q22](#)); relatively higher inflation makes it fall ([9708/12/F/M/25 Q27](#)). Options such as higher national income, more money supply or more demand-pull inflation raise imports or prices and push the rate **down**; a natural resource that **replaces imports** pushes it **up** ([9708/11/O/N/22 Q25](#)).
- **Two countries**: trade barriers put up by country Y cut country X's exports, so demand for X's currency falls ([9708/11/O/N/24 Q27](#)). Extra paperwork for a country's own importers cuts its imports, so supply of its currency falls and it appreciates ([9708/14/M/J/25 Q29](#)).
- **Demand for the US dollar**: foreign firms buying US firms need dollars ([9708/12/M/J/24 Q29](#)); dividends paid to foreigners are dollars being **sold** (supply).
- **A shifted curve on a diagram, find the cause**: a rightward shift in the supply of euros comes from more EU imports ([9708/12/M/J/25 Q30](#)).
- **Shift of one curve, movement along the other** ([9708/12/F/M/23 Q23](#)): speculators who think the dollar is undervalued buy dollars, so demand shifts right and the market moves **along** the supply curve.
- **Current account changes**: a large surplus means strong demand for the currency, so it appreciates and **import prices fall** ([9708/11/M/J/23 Q25](#)); a large deficit means it depreciates and **export prices fall** ([9708/12/O/N/25 Q26](#)).

Written parts (9 questions): 8-mark (a) parts ask for "two causes" or "one demand factor and one supply factor", with a diagram ([9708/22/F/M/26 Q5](#) (a), [9708/21/M/J/23 Q5](#) (a), [9708/21/O/N/22 Q4](#) (a), [9708/21/M/J/21 Q4](#) (a)); data parts ask why a real currency moved (2–4 marks, [9708/23/M/J/24 Q1](#) (b)(i), [9708/21/O/N/23 Q1](#) (c), [9708/22/F/M/21 Q1](#) (d)).

1. **Define** appreciation or depreciation: the value of the currency rises (or falls) against other currencies, because demand for or supply of it on the foreign exchange market has changed (1 mark).
2. **Draw one diagram for each cause, showing only the curve that cause shifts.** This is the rule for every causes question in this note. Vertical axis "exchange rate" or "price of the zed in US\$" (**not** just "P" or "price"); horizontal axis "quantity of zeds"; label D, S, the shift and both equilibrium rates.
 - **Appreciation**: a rise in demand (diagram 2) and a fall in supply (diagram 3). These are the two "fully accurate diagrams" the 2026 mark scheme gave a mark each.
 - **Depreciation**: a rise in supply (diagram 4) and a fall in demand (drawn like diagram 2 with D2 to the left).
3. **Explain each cause as a chain** that ends at the curve: "higher interest rates than abroad → foreign savers move money into the country → they must buy zeds → demand for zeds shifts right → the zed appreciates."
4. **Answer the second half** (effects, or "consider") with the plans in types 2 and 6.

How the marks split (3 knowledge, 3 analysis, 2 evaluation): in 2026 the knowledge marks were the definition and one per cause on an accurate diagram; in June 2023 they went to the labelled diagram and the causes counted as analysis ([9708/21/M/J/23 Q5](#) (a)); in 2021–2022 there were 2 marks for the diagram and up to 3 per explained cause ([9708/21/M/J/21 Q4](#) (a)). The same answer scores under all of them: definition, labelled diagrams, a chain for each cause.

Variations:

- **Relative inflation** ([9708/22/O/N/22 Q4](#) (a)): higher inflation than trading partners makes exports dearer, so foreigners buy fewer and **demand for the currency falls**; imports become relatively cheaper, so residents buy more and **supply rises**. Both push the rate down.
- **Trade balance against interest rates** ([9708/22/M/J/25 Q5](#) (a)): a fall in the trade balance works through both curves (more imports → more supply; fewer exports → less demand). Interest-rate differences move hot money, which can be far larger and faster than trade flows, but how much depends on confidence in the country and on the other factors moving at the same time. Weigh the two, then conclude.
- **Data parts**: name the reason given in the extract (an interest-rate cut, inflation, low confidence, fear of a bank collapse) **and** say it reduces demand for the currency on the foreign exchange market, so its value falls. The identification alone earns only 1 of the 2 marks ([9708/23/M/J/24 Q1](#) (b)(i)).
- **Low interest rates while other countries raise theirs** ([9708/22/F/M/21 Q1](#) (d), 4 marks with a diagram): hot money leaves, so demand for the currency falls or supply rises; show the shift, the lower rate and the new quantity traded, and explain it.

2. Effects of a depreciation or appreciation (21 questions)

Multiple choice (13 questions):

1. **Start with prices**: depreciation means exports cheaper **in foreign currency** and imports dearer **in home currency**. Appreciation: the reverse.
2. **Then volumes**: depreciation raises export volume and cuts import volume ([9708/12/O/N/22 Q24](#)); appreciation cuts export volume ([9708/13/O/N/24 Q30](#)).
3. **Then the macroeconomy**: depreciation raises AD, real GDP and employment ([9708/12/F/M/26 Q29](#)) and adds **cost-push** inflation from dearer imports ([9708/11/O/N/25 Q26](#), [9708/11/M/J/25 Q30](#)). A worse current account with no offsetting factors means the rate depreciates and cost-push inflation rises ([9708/12/M/J/21 Q27](#)), and in the short run unemployment rises ([9708/12/O/N/24 Q25](#)).

Variations you will meet:

- **Which firm gains most from a depreciation?** One that sells mainly abroad and buys inputs at home ([9708/12/O/N/24 Q24](#)).
- **The exporter keeps its foreign price**: its home-currency revenue per unit rises, whatever the elasticity ([9708/12/O/N/22 Q26](#)). After a 10% fall in the pound, each dollar earned buys $1 \div 0.9$ times as many pounds, 11.1% more.
- **Two trading countries**: when one currency depreciates, its producers gain sales and the other country's lose them ([9708/11/M/J/22 Q19](#)).

- **Immediate effect of a devaluation:** only prices have changed yet; the home-currency price of imports rises (9708/12/F/M/21 Q22).

Written parts (8 questions): 4-mark data parts ("consider whether the falls in the currency may reduce the current account deficit", 9708/22/M/J/25 Q1 (c), 9708/21/M/J/24 Q1 (c)), 4–6-mark parts on producers or industries (9708/23/M/J/24 Q1 (b)(ii), 9708/21/O/N/23 Q1 (d)), the second half of 8-mark (a) parts (9708/21/M/J/23 Q5 (a), 9708/22/F/M/23 Q5 (a)) and 12-mark (b) essays (9708/24/M/J/25 Q5 (b)).

Answer plan:

1. **Define** the change: a fall (or rise) in the value of a floating currency against other currencies, caused by changes in demand and supply.
2. **Chain 1, trade:** export prices fall in foreign currency and import prices rise in home currency → export volumes rise and import volumes fall → net exports ($X - M$) rise → the trade or current account balance improves, AD shifts right → real output, national income and employment rise.
3. **Chain 2, costs:** dearer imported raw materials and components → firms' costs rise → SRAS shifts left → cost-push inflation, and producers using imported inputs become **less** competitive. Consumers pay more for imported goods.
4. **Evaluate** with the conditions from "Understand it": PED of exports and imports, the share of net trade in AD, reliance on imported inputs, spare capacity, time. Each "it depends" must say **why** it matters.
5. **Conclude** on the exact words of the question ("always", "likely", "extent", "all industries").

For an appreciation, run the same two chains the other way: chain 1 becomes the cost (exports dearer, net exports and AD fall) and chain 2 the benefit (cheaper imports, lower costs and inflation).

Mark sizes:

- **4-mark data part:** up to 3 marks for the explained chain (lower export prices **and** higher import prices, then the effect on volumes and the balance; a clear definition of depreciation can be one of the 3) and 1 reserved for evaluation, usually PED. You don't need to name the Marshall–Lerner condition.
- **Producers** (9708/23/M/J/24 Q1 (b)(ii), 4 marks): up to 3 for an explained chain (dearer imported materials → higher costs → less competitive, or cheaper exports → more sales), 1 for evaluation such as reliance on imported materials.
- **All industries** (9708/21/O/N/23 Q1 (d), 6 marks): an appreciation raises export prices and lowers import prices, so the terms of trade improve; exporters lose sales while firms using imported inputs gain. Deal with **both** exports and imports: one side alone is capped at 2.
- **8-mark (a) parts:** the analysis marks need **both** the benefits and the drawbacks; the 2023 mark scheme allowed at most 2 of the 3 analysis marks for only one of them. Then 2 evaluation marks, the second for a justified conclusion.
- **12-mark (b) essay:** 8 for knowledge and analysis (Level 3 needs both benefits and drawbacks, explained), 4 for evaluation. A one-sided answer gets no evaluation marks.

Variation: the **terms of trade** (export price index ÷ import price index × 100, 9708/23/O/N/22 Q4 (a)): a depreciation lowers export prices in foreign currency and raises import prices, so the terms of trade **worsen**; an appreciation improves them. Elasticities decide the trade **balance**, not the terms of trade.

3. Fixed, managed and floating systems (10 questions)

Now A Level content (topic 11.2), but 2021–2024 AS papers asked about it. The short version:

- **Fixed** rate: set by the government or central bank. Under downward pressure (a current account deficit, lost confidence) the central bank **buys** its own currency with **reserves** or raises interest rates; reserves run down (9708/13/M/J/22 Q24) and pressure to **devalue** grows (9708/12/M/J/22 Q23). A devaluation aims to raise AD through net exports (9708/12/M/J/21 Q20). With inflation above its partners', a fixed rate cannot fall to help, so exports fall and imports rise (9708/13/M/J/21 Q21).
- **Diagram** (9708/21/O/N/21 Q4 (a)): the fixed rate is a horizontal line above the new market equilibrium; the central bank buys the excess supply, shifting demand back up to the fixed rate. Label the vertical axis "exchange rate".
- **Holding a band** (9708/11/O/N/22 Q20): to stop a fall, cut the supply of the currency (controls on investment abroad) or buy it.
- **Floating versus fixed**: floating gives interest-rate independence (9708/12/F/M/23 Q27) and needs no reserves, but makes traded-goods prices less predictable (9708/11/M/J/24 Q24); fixed gives certainty but needs reserves and can clash with other aims (9708/21/M/J/22 Q4 (a)). A **managed float** means the central bank intervenes more often than under a free float (9708/12/F/M/21 Q21).

4. Define the terms and explain how a floating rate is set (5 questions)

1. **Exchange rate**: the price of one currency in terms of another (an example such as Z1 = \$0.50 also shows it).
2. **Floating rate**: set by market demand for and supply of the currency, not by the government. So any change in a floating rate comes from those two curves, not from trade agreements and not as a "continuous" rise (9708/14/O/N/25 Q30).
3. **Appreciation or depreciation**: say the value **rises** (or falls) against other currencies, then show it on a currency diagram with the new equilibrium rate marked (9708/22/F/M/23 Q5 (a); 9708/22/F/M/24 Q4 (a), where knowing that a fall in demand or a rise in supply causes a depreciation earned a mark each).

Variations: the currency swings most when demand for and supply of it are both price **inelastic** (9708/14/M/J/22 Q25); a trade-weighted exchange rate (A Level now) takes account of the **share of trade** done with each partner (9708/12/M/J/22 Q20).

5. Read or calculate from exchange-rate data (5 questions)

1. **Check how the rate is quoted**. "Units of currency per US\$" is the price of the dollar: a **bigger** number means the currency has **depreciated**.
2. **Turn it into the currency's value** (divide 1 by the rate) if you need a percentage change in the currency itself, or compare the direction only if that is all the question asks.
3. **Percentage change** = $\frac{\text{new} - \text{old}}{\text{old}} \times 100$.

Variations:

- **Smallest appreciation against the dollar (9708/12/O/N/24 Q30)**: only currencies whose number per dollar **fell** appreciated. One going from 6.91 to 6.90 rose in value by 0.14%; one going from 0.99 to 0.94 rose by 5.32%. The smallest is the first.
- **A large fall (9708/11/M/J/24 Q28)**: the Turkish lira went from 2.83 to 8.15 per dollar, so it lost 65% of its dollar value; the cause is inflation far above its partners'.
- **The pound falls against the dollar (9708/11/M/J/25 Q30)**: imports become dearer, so the short-term effect is more cost-push inflation.
- **Two graphs quoted different ways (9708/12/F/M/23 Q17)**: a rise in "US\$ per £" is a rise in the pound; a rise in "£ per €" is a **fall** in the pound against the euro.
- **Trade-weighted index (A Level now, 9708/14/M/J/22 Q21)**: from 100, with 60% of trade with Y (the currency falls 20% against Y's) and 40% with Z (it rises 10% against Z's): $0.6 \times 80 + 0.4 \times 110 = 92$.

6. An exchange-rate change on an AD/AS diagram (4 questions)

Multiple choice (9708/12/O/N/25 Q28, 9708/13/M/J/22 Q26), where the question tells you the sum of the elasticities is more than one):

1. Depreciation or devaluation → net exports rise (if demand for exports and imports is elastic enough) → **AD shifts right**.
2. The new equilibrium has a **higher** price level **and** higher real output.
3. An appreciation shifts AD **left**: lower real output and price level.

Written ("consider whether an appreciation is likely to reduce real output", **9708/22/F/M/26 Q5 (a)**; "whether a depreciation is likely to increase real output", **9708/22/F/M/24 Q4 (a)**), 3 analysis marks and 2 evaluation marks:

1. **Price effect (1)**: exports dearer abroad and imports cheaper at home (for an appreciation).
2. **To output (1)**: net exports ($X - M$) fall → AD shifts left → real output and employment fall.
3. **Why it may not (1)**: demand for exports and imports may be price inelastic; net trade may be a small share of AD; cheaper imported inputs cut costs and shift SRAS right. The 2026 mark scheme allowed only 2 of the 3 marks without this other side.
4. **Evaluate and conclude (2)**: weigh which effect is bigger for this economy (openness, PED, spare capacity: a depreciation raises output only if the economy is not at full capacity), then a justified conclusion.

Worked examples

Example 1

On 1 March, US\$1 = 16 dorins. On 1 June, 1 dorin = US\$0.05. Which statement is correct?

A The dorin depreciated by 20% against the US dollar.

B The dorin depreciated by 25% against the US dollar.

C The dorin appreciated by 25% against the US dollar.

D The US dollar depreciated by 20% against the dorin.

[1]

Put both rates the same way round. In March 1 dorin was worth $1 \div 16 = 0.0625$ dollars; in June it is worth 0.05 dollars, so the dorin's value changed by $\frac{0.05 - 0.0625}{0.0625} \times 100 = -20\%$. In June \$1 buys $1 \div 0.05 = 20$ dorins, so the dollar **appreciated** by $\frac{20 - 16}{16} \times 100 = 25\%$. B takes the dollar's 25% rise and applies it to the dorin; D takes the dorin's 20% fall and applies it to the dollar. The answer is **A** (1).

Example 2

Country P has a floating exchange rate. Which change would make P's currency depreciate through a shift of the **demand** curve for it?

A Residents of P buy more imported phones.

B Fewer foreign tourists visit P after airfares rise.

C P's central bank raises its interest rate above those of other countries.

D Residents of P receive more dividends from shares they own abroad.

[1]

A raises the **supply** of P's currency (the right result, the wrong curve). C and D raise demand for it, so it would appreciate. Fewer foreign tourists need fewer units of P's currency to pay for hotels and meals, so demand shifts left and the currency depreciates. The answer is **B** (1).

Example 3

Kestria is a made-up country with a floating currency, the kestra. Last year its central bank raised its interest rate from 3% to 5.5% while rates abroad stayed at 2%. A new solar power programme also cut Kestria's imports of oil by a third. Over the year the kestra rose from \$0.80 to \$0.88. Kestria imports most of its food, but few of the inputs its factories use.

With the help of diagrams, explain how the two events caused the kestra to rise, and consider how far the rise will lower Kestria's inflation rate. [8]

Model answer, marked like the 2026 point-based scheme (3 knowledge, 3 analysis, 2 evaluation):

The kestra has **appreciated**: its value rose by $\frac{0.88 - 0.80}{0.80} \times 100 = 10\%$ against the dollar, because demand for and supply of kestras on the foreign exchange market changed (**1, AO1**). Kestria's interest rate is now 3.5 percentage points above rates abroad, so foreign savers move money into Kestrian banks; to do so they must buy kestras, so the demand curve shifts right from D1 to D2 on a diagram like diagram 2, and the rate rises (**1, AO1**). With a third less oil to buy, Kestrian importers sell fewer kestras to get dollars, so the supply curve shifts

left from S1 to S2 on a second diagram like diagram 3, and the rate rises again (**1, AO1**). (Each diagram has "price of the kestra in US\$" on the vertical axis and "quantity of kestras" on the horizontal, with both equilibrium rates marked.)

The rise makes imports cheaper in kestras: imported food costs less in the shops, which lowers the price level directly, and cheaper imported inputs lower firms' costs, so SRAS shifts right (**1, AO2**). Exports become dearer in dollars, so if foreign demand for them is price elastic, export sales fall, net exports and AD fall, and demand-pull inflation eases (**1, AO2**). But inflation may fall less than this suggests: Kestria's factories use few imported inputs and now buy less oil, so the cost saving is small; shops may keep the lower import prices as profit; and if demand for Kestria's exports is price inelastic, export sales hardly fall, so AD barely moves (**1, AO2, the other side**).

So the size of the fall depends on what is imported. Food is a large part of what households buy, so cheaper food imports pull measured inflation down quickly, while the cost-push and AD routes are weak here (**1, AO3**). Overall the rise should lower Kestria's inflation rate, mainly through cheaper food, but by much less than 10%: few factory inputs are imported and part of the saving may be kept as profit (**1, AO3, justified conclusion**).

(Knowledge 3, analysis 3, evaluation 2: **8/8**.)

Example 4

Kestria is close to full employment, and its inflation rate of 6% is well above the central bank's 2% target. Over six months the kestra rises by 12%. Assess whether Kestria's government should welcome the appreciation. **[12]**

Model answer (outline of each paragraph):

- Terms.** An appreciation is a rise in the value of a floating currency, caused by more demand for it (diagram 2) or less supply of it (diagram 3). "Close to full employment" means a change in AD mostly changes prices. (*Accurate knowledge, part of Table A.*)
- Why welcome it.** Imports are cheaper in kestras, so firms' costs fall and SRAS shifts right: less cost-push inflation. Exports are dearer abroad, so net exports and AD fall (AD/AS diagram, AD shifting left); with no spare capacity this mostly cuts demand-pull inflation, not output. Both move inflation towards 2% without higher interest rates, and cheaper imports raise real incomes. (*Developed chains: Table A.*)
- Why not.** If demand for exports is price elastic, a 12% rise costs exporters and import-competing firms sales and jobs, and the current account worsens. A rise driven by hot money can reverse quickly, and the uncertainty discourages investment. (*The other side, explained: Table A Level 3 (6–8 marks), here 8/8.*)
- Evaluation.** It depends on the share of imports in spending and inputs, on PED of exports, on how much of AD is net trade, and on whether the rise lasts. With inflation three times the target and no spare capacity, the inflation gain is large and the output cost small. (*Table B top level (3–4 marks).*)
- Conclusion.** Broadly welcome it: it lowers inflation when the economy cannot produce more anyway, but watch for job losses in export industries if the kestra keeps rising. (*Justified conclusion: Table B, here 4/4.*)

(Table A Level 3: 8; Table B: 4; **12/12**.)

Common mistakes

- **Labelling the vertical axis "P" or "price".** The November 2021 report (central bank diagram) and the June 2023 report (causes of a depreciation) both found this. On a currency diagram it must say "exchange rate" or "price of the zed in US\$"; the mark schemes give the diagram mark only then.
- **Leaving the diagram out.** The March 2023 and March 2026 reports both found answers with no diagram, or an inaccurate one, where the question asked for it. Draw one per cause.
- **Not saying what appreciation or depreciation means.** The March 2023 report notes answers that described an appreciation without ever stating that the currency's value goes up; that statement is itself worth a mark, so write it.
- **Naming a cause without the link to the market.** In June 2024 weaker answers named why the lira fell but not why that cut demand for it on the foreign exchange market, so they got 1 mark of 2. Say "so demand for the currency fell, and its value fell".
- **Mixing up which currency the price is in.** A depreciation lowers the **foreign-currency** price of exports and raises the **home-currency** price of imports.
- **Asserting effects without saying when they happen.** In March 2023 answers wrote that an appreciation means exports fall, without the conditions, and got no credit; in November 2021 a fall in the exchange rate was often called a disadvantage with no reason, when it can also help exports. Give the chain and the condition (PED, spare capacity).
- **Forgetting import costs.** In March 2026 some candidates did not see that a depreciation raises the prices of imports, so the costs of finished goods and raw materials go up and so does inflation.
- **Assuming output must fall after an appreciation.** In March 2026 several answers did this without considering cheaper imports.
- **Mixing up depreciation and devaluation.** A floating rate depreciates; a fixed rate is devalued.
- **Ignoring "consider" or "extent".** Reports in June 2023 (whether a depreciation is always good) and June 2024 (how far a depreciation could help the trade balance) both found most answers stopped once the chain was explained, with little or no judgement. The last mark (or the evaluation marks) needs a reasoned "it depends" and a conclusion.

How to get the marks

- **Multiple choice:** ask "who buys or sells the currency, and does that raise or lower its value?" For effects, write the chain: price in which currency → volume → net exports → AD.
- **"Explain why"** (2 marks): the reason from the data **and** its effect on demand or supply of the currency.
- **"Consider"** (4 marks): up to 3 for the chain, 1 for a reasoned "it depends", usually PED.
- **8-mark (a) parts** are point-marked (3 knowledge, 3 analysis, 2 evaluation); analysis needs both sides, and the last mark is a justified conclusion.
- **12-mark (b) parts** are level-marked (8 + 4). Level 3 needs both sides explained; a one-sided answer gets **no** evaluation marks.
- **Diagrams:** one per cause, axes "exchange rate" and "quantity of [currency]", shift and both equilibria marked, and refer to each one in your text.

- **"Always", "only", "likely"**: find the case where the claim fails (inelastic demand, imported inputs, full employment) and say how much it matters here.

Quick check

1. The exchange rate moves from 1 kora = \$1.25 to 1 kora = \$1.40. (a) Has the kora appreciated or depreciated, and by what percentage? (b) What happens to the price in koras of a US good priced at \$56?
2. For each event, say which curve in the market for zeds shifts, which way, and what happens to the exchange rate: (a) more foreign tourists visit the zed country; (b) residents buy more imported cars; (c) speculators expect the zed to rise.
3. A hotel in Tamaria charges T4,500 a night, and most of its guests come from Japan. The tal falls from 1 tal = ¥32 to 1 tal = ¥28, and the hotel keeps its price in tals. (a) By what percentage has the tal changed in value against the yen? (b) What is the price of a night in yen before and after? (c) If the price elasticity of demand of Japanese guests is 1.6, estimate the percentage change in nights booked and in the hotel's revenue in tals.
4. Explain, using AD/AS analysis, why a depreciation may raise the price level. **[2]**
5. Explain one reason why a depreciation may not reduce a current account deficit. **[2]**

Answers

- (a) Each kora buys more dollars, so the kora has **appreciated**: $\frac{1.40-1.25}{1.25} \times 100 = 12\%$. (b) The price falls from $56 \div 1.25 = 44.80$ koras to $56 \div 1.40 = 40.00$ koras.
- (a) Demand for zeds shifts right; the zed appreciates. (b) Supply of zeds shifts right; the zed depreciates. (c) Demand shifts right as speculators buy zeds now; the zed appreciates.
- (a) $\frac{28-32}{32} \times 100 = -12.5\%$: the tal has **depreciated** by 12.5%. (b) $4500 \times 32 = 144,000$ yen before and $4500 \times 28 = 126,000$ yen after, also 12.5% cheaper. (c) Nights booked rise by about $1.6 \times 12.5 = 20\%$. The price in tals has not changed, so revenue in tals rises by the same 20%: elastic demand makes the depreciation good for this exporter.
- Exports become cheaper abroad and imports dearer, so net exports rise and AD shifts right, raising the price level (1). Imported raw materials also cost more, so firms' costs rise and SRAS shifts left, causing cost-push inflation (1).
- If demand for exports and imports is price inelastic (1), export volumes rise only a little while the country pays more for almost the same imports, so spending on imports may rise and the deficit can stay the same or get worse (1).

Past questions to try

- **9708/12/F/M/23 Q23**: a shift of demand and a movement along supply in the dollar market.
- **9708/12/O/N/22 Q26**: an exporter's home-currency revenue after a depreciation.
- **9708/22/M/J/25 Q5**: (a) the trade balance and relative interest rates as causes of a change.
- **9708/22/F/M/24 Q4**: (a) whether a depreciation is likely to increase real output.