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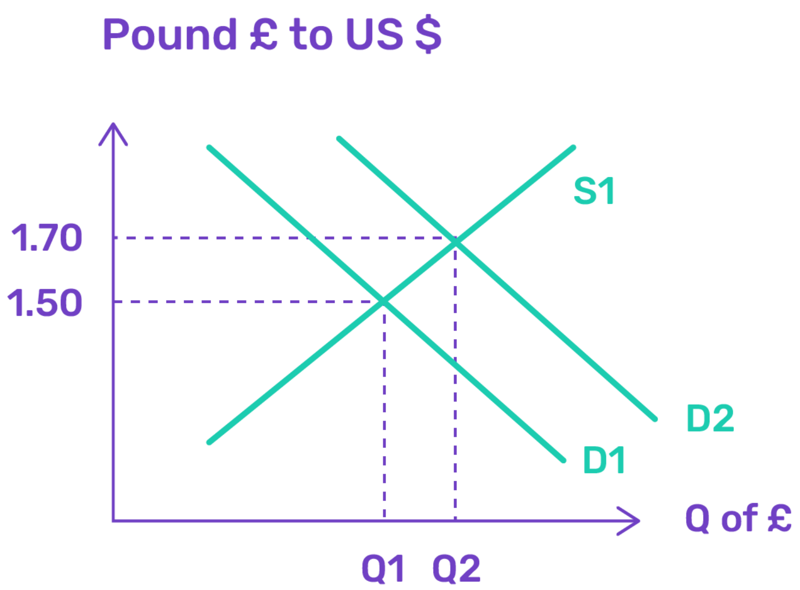
Economics lesson 3 – Answer sheet

Lesson 3 – Answer sheet

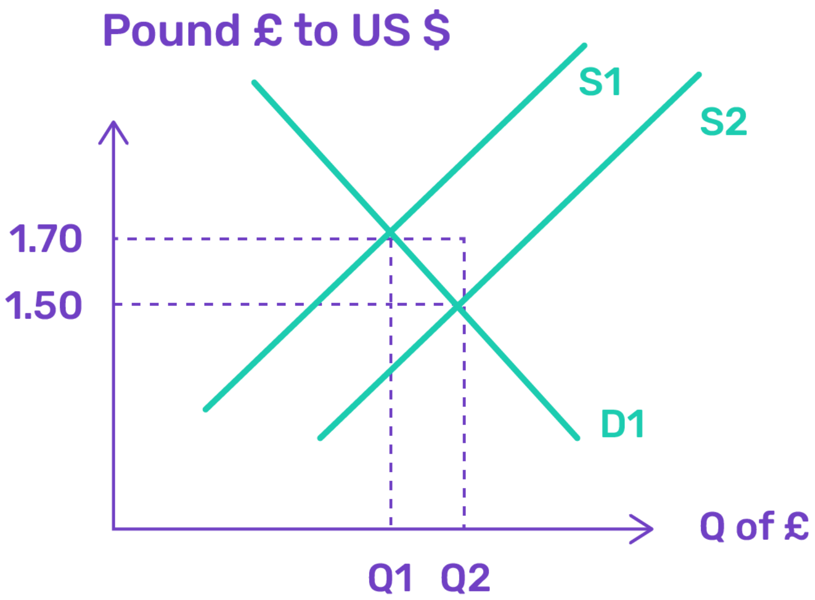
What is an exchange rate?

Consider how the exchange rate is determined through the interaction of supply and demand.

Exchange rate - The price of one currency in terms of another.



The demand curve (D) is the demand for pounds. This comes from overseas economic groups who want pounds to buy British goods, services and financial assets from the UK.



The supply curve (S) is the supply of the pound. This comes from UK economic groups who supply their pounds in exchange for another currency that they can use to buy goods, services and financial assets from other countries.

In the summer of 2007, the UK had a strong £. It was equivalent to nearly $2. Consider the effects of a strong exchange rate on consumers and producers.

- Imports become cheaper – producers see a fall in the costs of their raw materials.
- A better standard of living.
- Exports become expensive - this will lead to a fall in the demand for British goods.
- Increased holidays abroad.
- A fall in interest rates – BoE may lower interest rates to make borrowing cheaper and attractive. This will allow businesses to become more productive and internationally competitive.
- A fall in the inflation rate – due to total demand falling. A rise in imports and a fall in exports will lead to a downward pressure on the price level.
- A rise in the current account deficit

In June 2016, the UK voted to leave the EU. This led to a loss of confidence in the UK economy. The £ depreciated significantly. Consider the effects of a weak exchange rate on consumers and producers.

- A rise in the price of imports - this should reduce for them.
- A rise in exports, as they become cheaper.
- A rise in domestic GDP, contributing to increased economic growth.
- A decrease in unemployment.
- A rise in the current account surplus.
- A rise in inflation.

Activity

Nicolas is a manager at Clément's in London, an exclusive hotelier. He is currently working with the finance team to set prices for their busy summer season. Nicolas and the finance team need to decide whether they should raise or lower their prices.

The table below shows exchange rates for countries where the UK's customers come from.

Country	Exchange rate
USA	$1.26
France, Spain, Italy	€1.17
China	9.17 Chinese Rembini
UAE	4.62 Dirham
Australia	$1.96

In groups of four, analyse the data that you have been given for the countries where the UK's customers come from.

1. Identify which country has the strongest exchange rate.
2. Should Nicolas and the finance department at Clément's increase or decrease their prices?
3. Consider any other factors that the team at Clément's might consider when deciding their prices.

1. UK has a stronger exchange rate in comparison to the countries listed.
2. Clément's should decrease their prices, as the countries where UK's consumers come from have weak exchange rates. A weak exchange rate will make it more expensive for consumers in those countries to go on holiday. If UK hotels were to reduce prices, they would be more attractive for customers from the USA, France, Italy, Spain, China, UAE and Australia.
3. However, Clément's could take advantage of the summer being the peak season to travel, as schools are closed etc. For many people travel during this time will be a necessity (inelastic demand), so would be willing to pay a high price to stay in a London hotel.