1. Discuss the main reasons why exchange rates are often so unstable.

*Answers may include:*

In a free floating exchange rate system the exchange rate is determined by supply of the currency to the foreign currency market and demand for the currency in the foreign currency market. As supply and demand conditions change this will change the exchange rate. Changes in supply and demand may occur due to changes in interest rates, inflation rates, the quality of goods and services, government trade policy and incomes. Speculators will also play a role in the value of the currency. If speculators believe a currency may increase in value in the future they would buy now to sell at a later date. As these different factors change regularly the exchange rate fluctuates greatly.

2. Discuss the main factors influencing the level of investment in an economy.

*Answers may include:*

The level of investment in capital goods depends on the expected returns from a project compared to the cost of borrowing. The expected returns will depend on factors such as the expected level of sales and the expected costs compared to the initial costs. These are based on forecasts of the future and therefore will change as expectations of future market conditions change. If managers are optimistic about the future they will expect higher returns and investment is likely to increase. The cost of borrowing may be the interest rate. With a higher interest rate the cost of borrowing increases and this means less projects are now financially viable.

3. To what extent does a change in share price of a company matter?

*Answers may include:*

The share price reflects the market value of a company. If the share price increases the market value (or market capitalization) increases and this means that the owners have an asset that is worth more. This increases their wealth and may lead to more spending. It also means they are likely to feel positively towards the managers. A higher share price also means:

- The company is more expensive to buy which may deter potential takeovers
- If more shares are issued in the future it may be possible to sell them at a higher price and raise more money

Many pension funds are invested in shares and therefore movement in share prices can have an effect on a large percentage of the population.