# Currency Devaluation vs Currency Depreciation

A devaluation occurs when a country makes a conscious decision to lower its exchange rate in a fixed or semi-fixed exchange rate regime; while

A depreciation is when there is a fall in the value of a currency in a floating exchange rate. Currency depreciation can occur due to factors such as economic fundamentals, interest rate differentials, political instability, or risk aversion among investors.

**Definitions**

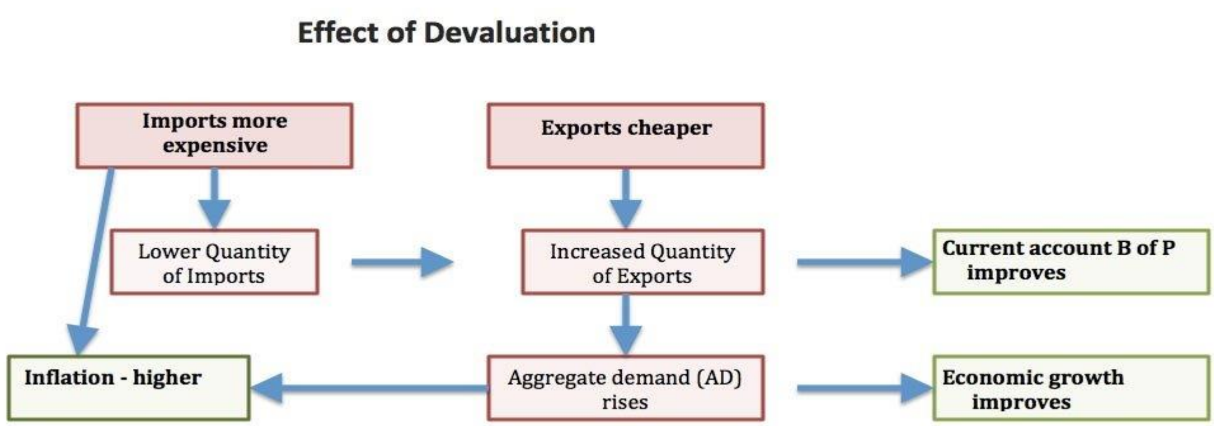
A fixed (or pegged) rate is a rate the government (central bank) sets and maintains as the official exchange rate e.g. the value of the Pound Sterling fixed against the Euro at £1 = €1.1

In a semi-fixed exchange rate, the rate is allowed to fluctuate between a specified range before an institution, usually a central bank, will intervene. For example, the Pound Sterling could fluctuate between a target exchange rate of £1 = €1.05 - €1.15.

A Floating Exchange Rate: This is when the government does not intervene in the foreign exchange market but allows market forces to determine the level of a currency.

While devaluation is the deliberate downward adjustment of the value of a country's currency by the government through the Central Bank, depreciation on the other hand is similar but arising from the effect of the demand and supply forces.

**Effect of Currency Devaluation/Depreciation**



One reason a country may devalue its currency is to combat a **trade imbalance**. Devaluation reduces the cost of a country's exports, rendering them more competitive in the global market, which, in turn, increases the cost of imports. If imports are more expensive, domestic consumers are less likely to purchase them, further strengthening domestic businesses. Because exports increase and imports decrease, there is typically a better balance of payments because the trade deficit shrinks. In short, a country that devalues its currency can reduce its deficit because there is greater demand for cheaper exports.

While devaluation or depreciation of a currency may be an attractive option, it can have negative consequences. Increasing the price of imports protects domestic industries, but they may become less efficient without the pressure of competition.

Higher exports relative to imports can also increase aggregate demand, which can lead to higher gross domestic product (GDP) and inflation. Inflation can occur because imports become more expensive. Aggregate demand causes demand-pull inflation, and manufacturers may have less incentive to cut costs because exports are cheaper, increasing the cost of products and services over time.

**Devaluation / depreciation**

| Winners | Losers |
|---|---|
| • Exporters<br>• Domestic tourist industry<br>• Workers gaining jobs in export industry<br>• Economic growth might increase<br>• Current account deficit should improve | • Consumers who buy imports<br>• Residents who holiday abroad<br>• Firms who buy imported raw materials<br>• Those on fixed incomes/wages who see inflation rise faster<br>• Foreign exporters/tourist industry |

NB: Both **Currency Devaluation and Depreciation** have **similar pros and cons** as explained below.

**Advantages of Currency Devaluation/Depreciation**

- Cheaper and more competitive exports (to boost Exports): Currency depreciation/devaluation creates the impact of making exports cheaper to foreign markets. An increase in export demand can lead to more productivity in the country and the creation of employment opportunities in an effort to meet export demand.

- To reduce trade deficits: As exports begin to increase due to cheaper prices and imports decrease due to perceived higher prices from domestic consumers, it ultimately decreases trade deficits. Therefore, the devaluation/depreciation of domestic currency can reduce deficits through strong demand for less costly exports and more costly imports.

## Disadvantages of Currency Devaluation/Depreciation

- Costly Debt Rates: For an individual with debts outside the country, there is an additional cost on their debt repayment impacted by the currency depreciation/devaluation

- Imported Goods Cost More: When a country depreciates or devalues its currency, it makes it more expensive to purchase goods that are imported from other countries.

- Reduced Investments: It scares away potential investors in the economy. This is more noted with the rapid depreciation/devaluation of investment value. Investors keep away from investments that would reduce the value of their holding.

- Increases in Inflation. A greater demand for exports (will lead to an increase in Aggregate Demand) would eventually result in an increase in general price level.