30. Currencies and Exchange Rates

One of the most commonly items of trade is currency. **Investors come in many forms, from the average tourist buying a different currency before a holiday to giant pension and hedge funds who profit from speculating on the rising/falling prices of currencies**

The price of a currency is **relative** – it is measured in relation to the price of another currency, rather than itself

Why Does the Price of a Currency Change?

You often hear on the news 'the dollar has fallen in value against the euro..' **What does this mean?**

On **Monday:** €1 = $1
On **Tuesday:** €1 = $0.75

The main reasons for this:

1. **The economy.** If one economy using a certain currency appears to be weakening, then the price of the currency falls as demand falls
2. **Profitability:** investors will always aim to maxmise their return. If a country has high interest rates, government bonds (debt) and other investments will have a much greater return than countries with low interest rates. Investors will buy from the high interest rate economy, demand will soar and the value of the currency will rise.

Two Main Exchange Regimes

Floating

Governments via their Central Banks adjust the exchange rates to suit economic policies or in response to market perceptions (or to maintain harmonious trade relations)

Commonplace today especially in developed economies

Pegged/Fixed

Countries 'peg' or ride a stronger, respected and stable currency to build credibility, reduce instability and promote investment in their economies. Many European currencies pegged to the US$ after WW2 to rebuild their economies

Originally, many countries fixed their currencies to the value of gold (a fixed value) in a regime known as the Gold Standard

More common in the 19th and 20th centuries

Demand for a Currency

The **QD** (Quantity Demanded) of your currency in the 'foreign exchange market' depends on **3** **factors**

1. **The current exchange rate**
2. **The expected exchange rate**
3. **The interest rate (at home and abroad)**

Current Exchange Rate (CER)

>CER = **<QD of your currency**

- **High exchange rate** = More expensive exports = Less Desirable/Low Demand for goods = Low Demand for stuff priced in your currency (exports)
- **Low exchange rate** = High expectation of profits by currency investors (they expect the currency to get dearer so they buy now)

Expected Exchange Rate (EER)

>EER = >QD of your currency

Investors expect currency to get dearer so they buy now to sell at profit later

The Interest Rate (IR)

>IR = >QD of your currency (and your assets)

Higher interest rate = Higher rate of return (so investors buy more of assets priced in your currency)

Expected Exchange Rate (EER)

>EER = <Qs of your currency

Investors expect currency to get dearer. Those who hold your home currency will hold it to sell later (for profit then)

The Interest Rate (IR)

>IR = <Qs of your currency (and your assets)

Higher interest rate = Higher rate of return (so investors buy more of assets priced in your currency and supply is snapped up)

Current Exchange Rate (CER)

>CER = >Qs of your currency

- **High exchange rate** = Cheaper imports = Buying more foreign currency (using your home currency)
- **High exchange rate** = High expectation of losses by holding your home currency (so, you will dump your home currency and buy more profitable currencies)

Supply of a Currency

The **Qs** (Quantity Supplied) of your currency in the 'foreign exchange market' depends on **3 factors**

1. **The current exchange rate**
2. **The expected exchange rate**
3. **The interest rate (at home and abroad)**

Pros and Cons of a Strong Currency

Pros

- **Cheaper imports** = higher standards of living for citizens (import cheaper consumer goods/cheaper food) = More disposable income
- **Low inflation** by disciplining domestic producers and domestic wage demands (as your trade competitiveness erodes)
- Low inflation = Less upward pressure on **Interest rates**

Cons

- **Erosion in trade competitiveness** worsens **trade balance** (citizens import more and buy less at home)
- Weakness of exports reduces **economic growth** (domestic economy shrinks)
- Domestic demand and domestic industry suffers (**upward pressure on unemployment**)
- Mounting deficits bad for **investor confidence**