

Floating Exchange Rates



Assessment Objectives

Specific Expectations

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AO2	Explain how exchange rates are determined by demand and supply of a currency in the foreign exchange market
AO4	Draw diagrams illustrating exchange rate determination and exchange rate changes showing appreciation and depreciation.
AO4	Calculate prices of goods in different currencies.
AO2	Explain the various factors that may cause changes in demand and/or supply of a currency.
AO4	Calculate changes in the value of currencies, arising from changes in currency demand or supply.

Foreign Exchange and Exchange Rates

- **Foreign exchange** refers to foreign national currencies.
 - ▶ For any country, it refers to currencies other than its own.
 - ▶ **Foreign exchange market (FOREX)** are competitive markets linked to all domestic and foreign prices, where foreigners and domestic citizens swap dollars for foreign currency.
- **Exchange rate** the rate at which one currency can be exchanged for another.
 - ▶ The number of units of foreign currency that correspond to the domestic currency.
 - ▶ Can be thought of as the “price” of a currency, which is expressed in terms of another currency.
 - ▶ **Example:** 1 USD : 1.27 CAD \Leftrightarrow 1 CAD : 0.79 USD

Demand and Supply of Foreign Exchange

- **Who demands a country's currency?**

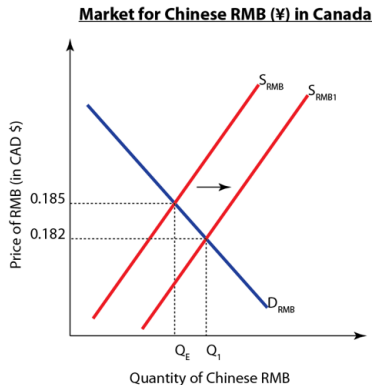
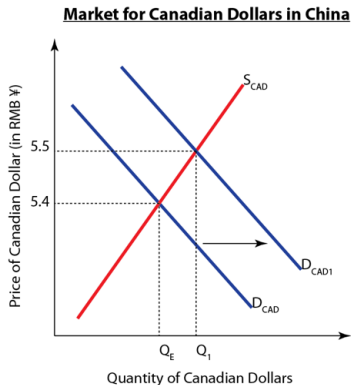
- **Foreign households, firms, and investors** to buy goods and services, capital, and assets from that country.
- As currency becomes less expensive, so to do the products made by that country so people will want to buy more of its goods and services. Therefore foreigners demand larger quantities of the currency as it depreciates.

- **Who supplies a country's currency?**

- **Domestic households, firms, and investors** supply their currency on the Forex market to exchange for foreign currencies so they can buy goods and services, capital, and assets in foreign countries.
- As prices rise, holders of that currency can obtain other currencies more cheaply and will want to buy more imported goods and will therefore give up more of their currency to obtain other currencies.

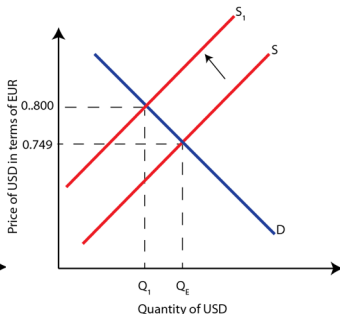
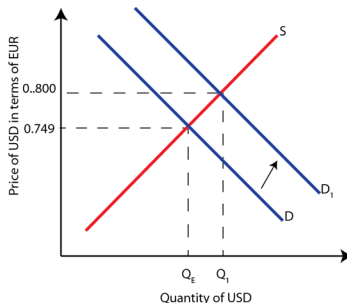
Demand and Supply of Foreign Exchange

- ▶ The demand for foreign currencies generates a supply of domestic currency.
- ▶ The demand for the domestic currency generates a supply of foreign currencies.



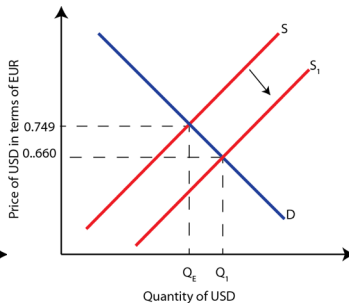
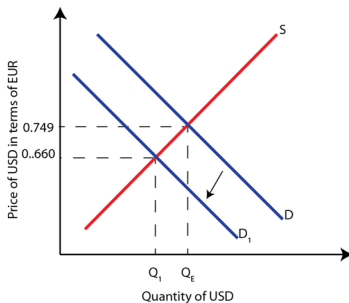
Floating Exchange Rate System

- **Floating exchange rate** an exchange rate determined entirely by market forces, or the forces of supply and demand.
 - ▶ There is no government intervention in the foreign exchange market to influence the value of the exchange rate.
 - ▶ **Appreciation** an increase in the value of a currency in the context of a floating exchange rate system or managed exchange rate system.



Floating Exchange Rate System

- When one currency appreciates it does so against all others in a floating exchange rate system, meaning that all others depreciate relative to it.
- ▶ **Depreciation** a decrease in the value of a currency in the context of a floating exchange rate system or managed exchange rate system.
 - When a currency depreciates, all other currencies appreciate relative to it.



Causes of Changes in Exchange Rates

T

Tastes and Preferences

- As demand for a country's exports increases, its currency appreciates
- As a country's imports increase, its currency depreciates

I

Relative Income Changes

- A country's level of income relative to other countries and the value of its currency change in opposite directions

P

Relative Price Levels

- Higher inflation in a country relative to other countries leads to currency depreciation

S

Speculation

- Expectation that a currency will appreciate leads to currency buying that contributes to bringing about the appreciation

I

Relative Interest Rates

- A country's interest rates and the value of its currency change in the same direction

Other Determinants

Investment from Abroad

- An increase in foreign investment from abroad results in currency appreciation

Central Bank Intervention

- If the central bank buys foreign currency the domestic currency will depreciate and vice versa