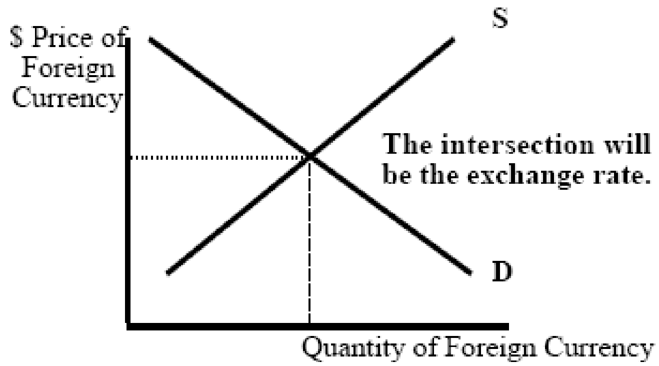
Foreign exchange is foreign currency needed to carry out international transactions. The exchange rate is the price of one currency measured in terms of another currency. Rates are determined by the interaction of the households, firms, private financial institutions, government and central banks that buy and sell foreign exchange.

Freely floating (flexible) exchange rates

The **demand** for any currency is downsloping because as the currency becomes less expensive to obtain, people will be able to buy more of that nation's Goods & Services and therefore need more of that currency.
The s**upply** is upsloping because as its price rises, holders obtain more of their currencies more cheaply and will want to buy more important goods and therefore give up more of their currency to obtain other currencies.

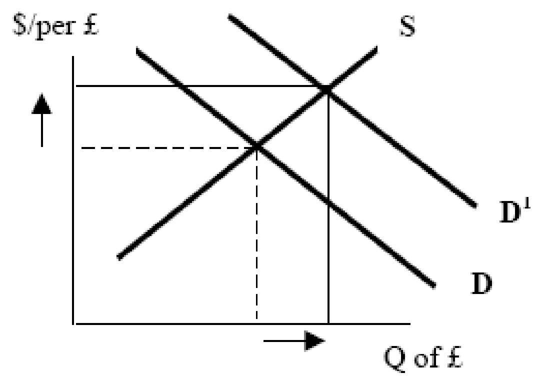


- **Depreciation**—value of currency has fallen; it takes more units of that country's currency to buy another's currency. Example: If the Rate had been $2 for 1 £ but now the rate is $3 for 1£, the dollar has depreciated.

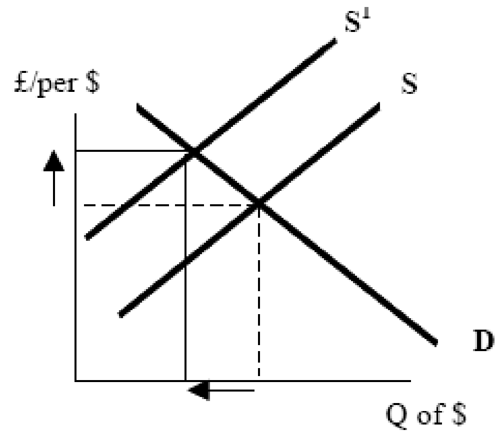
- **Appreciation**— value of currency has risen; it takes fewer units of that country's currency to buy another's currency. Example: If the Rate had been $2 for 1 £ but now the rate is $1 for 1£, the dollar has appreciated.

Determinants of exchange rates:	Example	Depreciates	Appreciates
Changes in tastes	Japanese autos decline in popularity in US	Japanese Yen	Dollar
	German tourists flock to US	German mark	Dollar
Changes in relative incomes	England is in recession; its imports decline while the US is growing increasing US imports	Dollar	Br. Pound
Changes in relative prices	Germany experiences a 3% inflation rate compared to US 10% inflation rate	Dollar	German Mark
Changes in relative interest rates	FED raises interest rates while Bank of England does not	Br. Pound	Dollar
Speculation	Currency traders believe France will have more rapid inflation than US	French Franc	Dollar
	Currency traders think that German interest rates will plummet relative to US. rates	German mark	Dollar

Graphic analysis:



These two graphs are linked since the labels are opposite

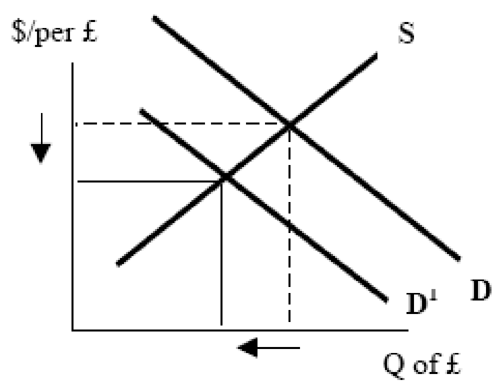


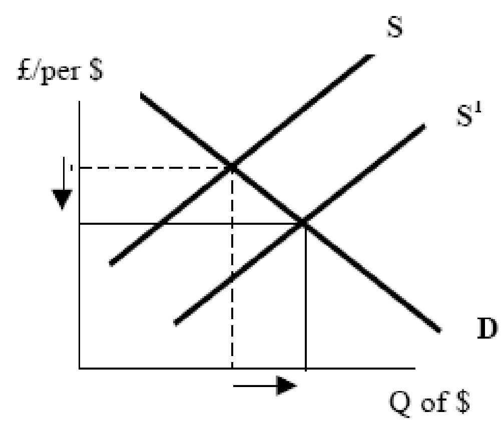
• England is in recession; its imports decline while the US is growing increasing US imports.

• The DEMAND for £ increases, causing the $/per £ to rise and Q of £ to increase showing that the dollar has depreciated.

• The SUPPLY for $ decreases, causing the £/per $ to rise and Q of $ to decrease showing that the dollar has depreciated.

Any <u>increase in the demand</u> for foreign exchange or any <u>decrease in its supply</u>, other things constant, causes an increase in the number of dollars required to purchase one unit of foreign exchange, which is a <u>depreciation</u> of the dollar.





• FED raises interest rates while Bank of England does not.

The DEMAND for £ will decrease causing the $/per £ to fall and Q of £ to fall showing an appreciation of the dollar.

The SUPPLY for $ will increase causing the £/per $ to fall and Q of $ to rise showing an appreciation of the dollar.

Any <u>decrease in the demand</u> for foreign exchange or any <u>increase in its supply</u>, other things constant, causes a reduction in the number of dollars required to purchase one unit of foreign exchange, which is a <u>appreciation</u> of the dollar.

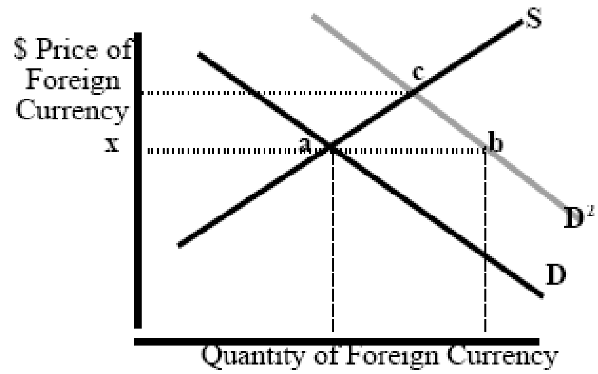
- ❖ **Appreciating (Strong) Dollar**—dollar is currently exchanging for more foreign currency.
  √ Imports are cheaper for Americans √ Exports are more expensive for foreigners

- ❖ **Depreciating (Weak) Dollar**—dollar is currently exchanging for less foreign currency.
  √ Imports are more expensive for Americans √ Exports are cheaper for foreigners

- ❖ **Strong dollar helps**: Businesses who import foreign goods for resale and American tourists and business people in foreign countries
- ❖ **Strong dollar hurts** : Business who export foreign goods for resale and American tourists and business people in foreign countries
- ❖ **Strong dollar makes the trade deficit worse since imports grow and exports decline.**

Flexible rates have the ability to automatically correct the imbalance in the balance of payments.
If there is a deficit in the balance of payments, this means that there is a surplus of that currency and its value will depreciate. As depreciation occurs, prices for goods and services from that country become more attractive and the demand for them will rise. At the same time, imports become more costly as it takes more currency to buy foreign goods and services. With rising exports and falling imports, the deficit is eventually corrected.

Using a Flexible Rate Exchange System
A shift in D to D^2 would cause a US balance of payments **deficit ab**; it would be corrected by a change in exchange rate noted at **c** which is higher than x



Disadvantages of Flexible Rate Exchange
1. Uncertainty and Diminished trade results if traders cannot count on future prices of exchange rates
2. Terms of trade may be worsened by a decline in the value of a nation's currency
3. Unstable exchange rates can destabilize an economy especially if exports and imports are a large part of the GDP.

Fixed Exchange Rates

- Rates that are pegged to some set value like gold or the US dollar.
- Official reserves are used to alleviate imbalance in balance of payments since exchange rates cannot fluctuate
- Trade policies must be used directly to control the amount of trade and finance
- Exchange controls and rationing of currency are bad for 4 reasons:
  1. distorts trade patterns,
  2. involves discrimination among importers,
  3. reduces freedom of choice by consumers,
  4. black market rates develop unless policed.
- Domestic macroeconomic adjustments are more difficult until fixed exchange. A persistent trade deficit may call for tight monetary policy and fiscal policies to reduce prices, which raises exports and reduces imports, but this can also cause recession and unemployment.