Test Yourself: Exchange Rates

The most important single central fact about a free market is that no exchange takes place unless both parties benefit.

Milton Friedman

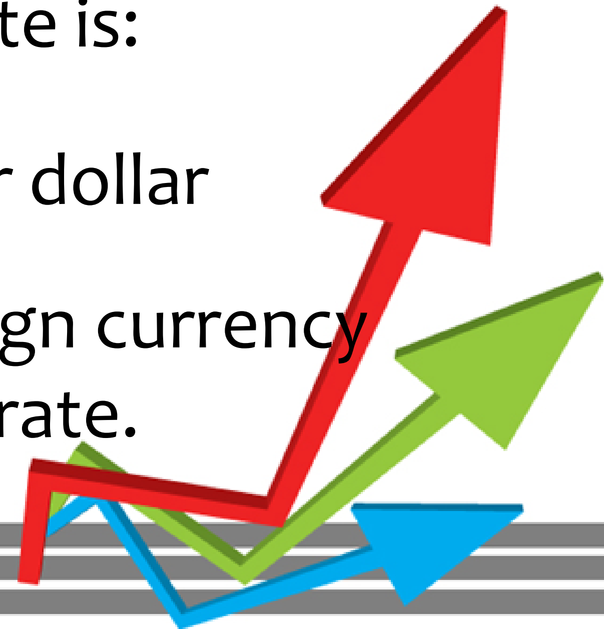
What is an exchange rate?

An exchange rate is the amount of one nation's currency that equals one unit of another nation's currency.

For example, if $1.81 is exchangeable for £1 (British pound), the exchange rate is:

1 / 1.81 = .552 pounds per dollar

The supply and demand for foreign currency determine the exchange rate.



What determines the exchange rate of a currency?

The exchange rate is determined by demand and supply in the forex (foreign exchange) markets where traders buy and sell currencies.

Chart: Supply and Demand for Dollars

D for $ (Japanese citizens)

S of $ (US citizens)

E

Price (yen per dollar)

200

150

100

50

0

100

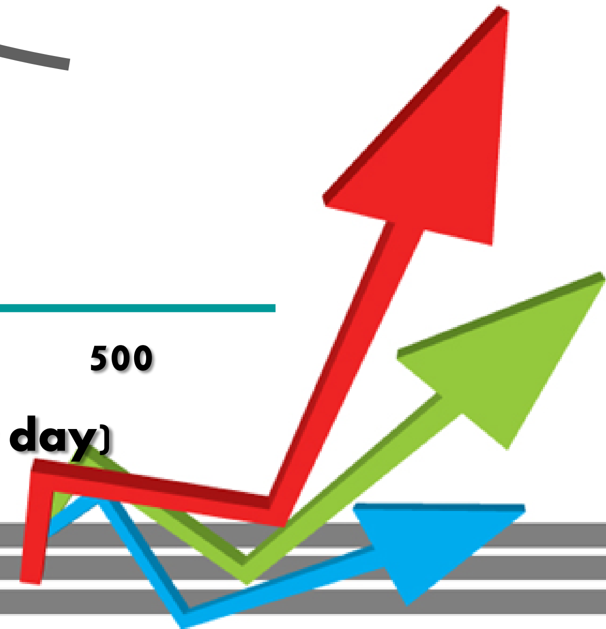
200

300

400

500

Quantity of dollars (millions per day)



What fundamental forces determine the demand and supply for currencies and can cause demand and supply to shift?

Fundamental forces that determine the demand and supply for currencies and can cause them to shift include:

- a country's income
- changes in a country's prices
- the interest rate in a country
- a country's trade policy

What effect do expectations of a change in exchange rates have?

Fundamentals can be overwhelmed by expectations of a change in exchange rates which become self-fulfilling.

The resulting fluctuations serve no real purpose and cause problems for international trade and the country's economy.

What effect does monetary policy have on exchange rates?

Expansionary monetary policy *lowers* exchange rates.

Contractionary monetary policy *increases* exchange rates.

What effect does fiscal policy have on exchange rates?

The net effect of fiscal policy is ambiguous because the interest rate effect and the income effect work in opposite directions.

What is the equilibrium price of currency?

The equilibrium price of a currency is the price at which the quantity of the currency demanded in a given time period equals the quantity of that currency supplied.

What happens when a currency depreciates?

When the price of the currency *falls* in relation to another currency it is said to have depreciated (lost value).

When a country's currency depreciates, its goods and services cost foreign consumers less and it pays more for foreign goods and services.

What happens when a currency appreciates?

When the price of a currency *rises* in relation to another currency, it is said to have appreciated (gained) in value.

When a country's currency appreciates, its goods and services cost foreign consumers more and it pays less for foreign goods and services.

What can cause a currency to change value?

A currency’s value changes if the demand and/or supply of the currency in the international market changes.

What can cause a change in the demand for a currency?

There can be a change in the demand for a currency if there is a change in any of the following:

- tastes and preferences
- relative price levels
- relative interest rates

Chart: Decrease in Demand

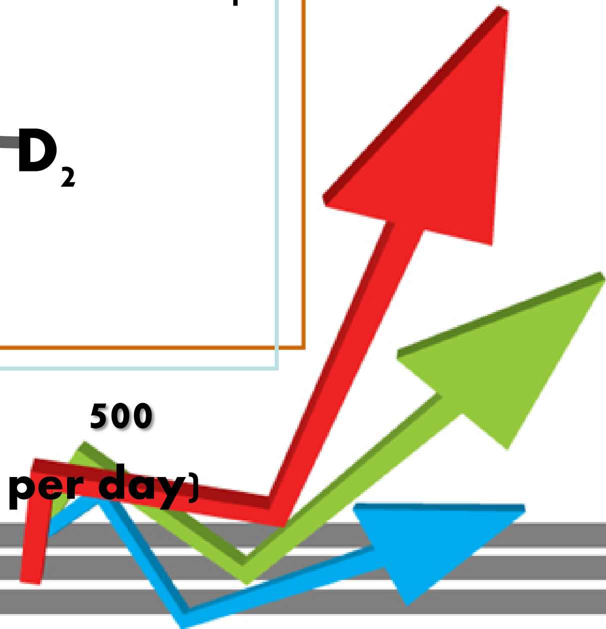
250
200
150
100
50

Price (yen per dollar)

S
E_1
E_2
D_1
D_2

100
200
300
400
500

Quantity of Dollars (millions per day)



What can cause a change in the supply of a currency?

There can be a change in the supply of a currency if there is a change in any of the following:

- relative incomes
- relative price levels
- relative interest rates

Chart: Decrease in Supply

250

200

150

100

50

Price (yen per dollar)

S
2

S
1

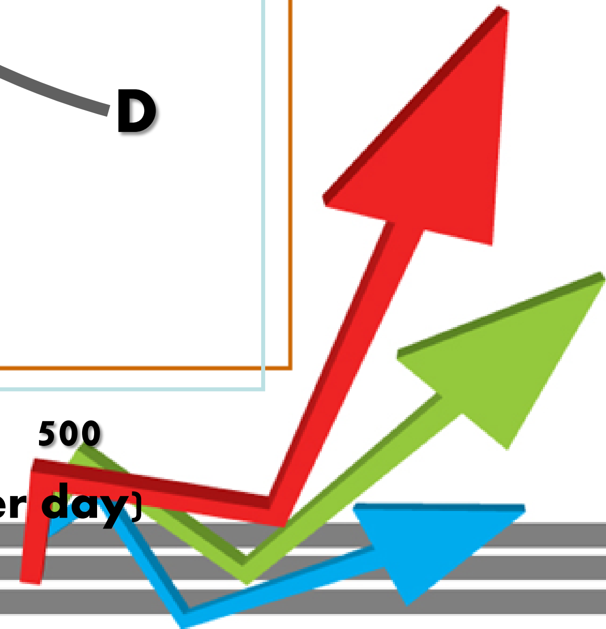
E2

E2

D

100 200 300 400 500

Quantity of Dollars (millions per day)



What happens when demand and/or supply in the currency market changes?

When demand and/or supply changes, the currency affected seeks a new equilibrium and the currency's value changes.

What are some advantages of fixed exchange rates?

Fixed exchange rates provide international monetary stability, force governments to make adjustments to meet international problems, and help control inflation.

What are some disadvantages of fixed exchange rates?

Fixed exchange rates create monetary instability if they become unfixed and force governments to make adjustments to meet international problems.

What is a flexible or floating exchange rate system?

A flexible or floating exchange rate system is a system in which exchange rates are permitted to vary with market supply and demand conditions.

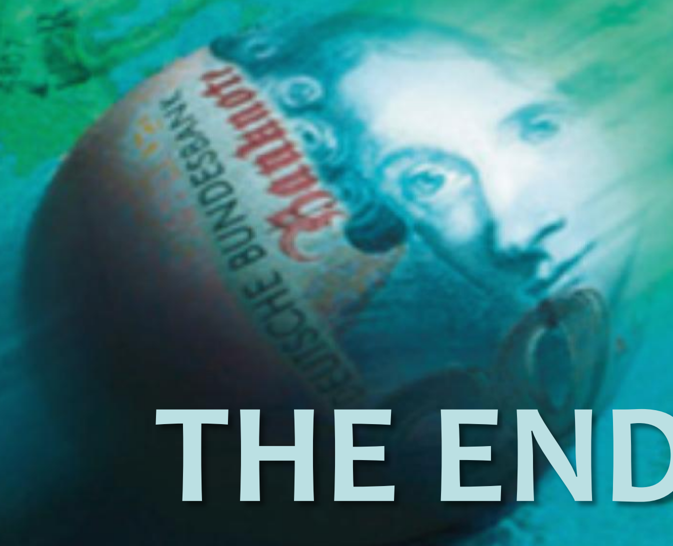
What are some advantages of flexible exchange rates?

Flexible exchange rates provide for orderly incremental adjustment of exchange rates, allow governments to be flexible in conducting monetary and fiscal policy, and do away with the need for foreign reserves.

What are some disadvantages of flexible exchange rates?

Flexible exchange rates allow speculation to cause large jumps in exchange rates and allow governments to be flexible in conducting monetary and fiscal policy.

How did you do?! If you didn't do as well as you'd like, review the margin notes and presentations and test yourself again.



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