Syllabus Reference 3.2: Determining the demand of a currency

http://economics.isdedu.de

What is an Exchange rate?

The exchange rate is the price of one currency in terms of another. it is the external value of a currency (the internal value is what the currency can buy in its own country and depends on the price level). The UK exchange rate is called the 'value of the pound' or 'the value of sterling'.

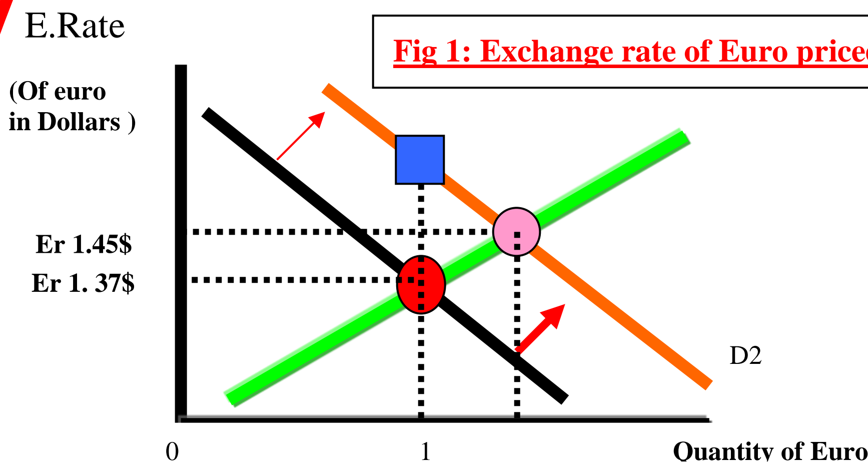
- In a floating exchange rate system, this price is determined by market forces of supply and demand.
- In a fixed system the Government intervenes to maintain the external value of the currency.
- See advantages + dis of fixed and flexible exchange rates

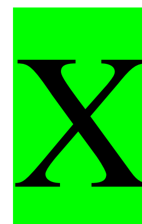
Key Terms:

Changes in the exchange rate

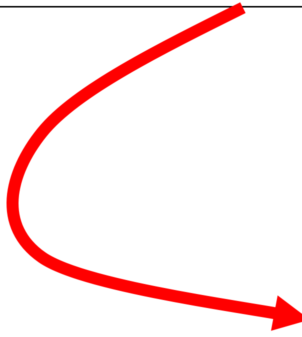
- In a floating system, an increase in the exchange rate is an appreciation; a fall is a depreciation.
- In a fixed system, if the rate at which it is fixed is increased, this is a revaluation. If a lower rate is fixed it is a devaluation.
- **Real exchange rate:** takes inflation into account. e.g. if the pound falls by 3% against the Euro, but UK inflation is 3% higher than Germany's, the real exchange rate is unaltered.

Fig 1: Exchange rate of Euro priced in US $



Demand: **3** Reasons for Demanding a Currency	 (can cause a significant injection effect in the macroeconomy. Remember AD = C + I +G+ **(X-M)**
1)Spend (foreigners demand more of the domestic	Exports FDI (capital inflows) EU money transfers

currency.	
2)Save (foreigners demand more of the domestic currency.	Foreigners saving in Domestic country because interest rates are attractively high More interest = more income earned
3)Speculate (foreigners demand more of the domestic currency.	Currency speculator **BUYS** domestic currency hoping to See the value of the currency rise (or fall) in the future. Look at George Soros story in webnote 324



Demand determined by:

1.Spend (foreigners) ↑
2.Save (foreigners) ↑
3.Speculate (foreigners buy domestic currency) ↑

The demand for pounds (or sterling)

This refers to the desire to change other currencies into pounds in order to:

- spend on UK goods and services
- save in UK banks and other financial institutions (long term capital movements)
- speculate on the currency in the hope that the pound will become more valuable in the future (these are short term capital movements; called 'hot money')

The demand for pounds will increase if:

1. **SPEND:** UK goods and services are demanded more, e.g. the quality improves, foreign incomes increase or they are relatively cheaper, more tourism into the UK = (MORE UK EXPORTS and therefore more demand by foreigners for the UK currency.)
2. ↑ **SAVE:** the UK interest rate increases, because there will be a greater desire to save in the UK to earn higher rates of return. To do so requires the investor to convert foreign currency into UK sterling.
3. ↑ **SPECULATE:** e.g. people think the value of the pound will rise (or fall) in the future so they buy it now- see the George Soros story in webnote 410.