Syllabus weight = 3

Syllabus Items:151 + 152

Webnote 322

Syllabus Reference 3.2: Determining the supply of a currency http://economics.isdedu.de

The supply of pounds STG (or sterling)
This refers to the desire to change pounds into other currencies in order to:

- buy overseas goods and services; travel abroad etc
- save in overseas financial institutions
- speculate on a foreign currency in the hope that it

The supply of pounds will increase if:

1. Overseas interest rates increase so saving abroad becomes more attractive
2. Overseas goods are demanded more if :

- they are better quality, variety etc
- Incomes rise
- foreign goods are relatively cheaper
- increased tourism abroad
- people think the pound will fall in the future so they sell it now

3. Note that the supply of a currency is ultimately determined by the government bank which has the sole right to issue legal tender.

What happens if the exchange rate falls ? It depends on how elastic / inelastic the demand is for imports

- If the exchange rate falls, the price of imports in the domestic currency increases - this will reduce the amount of imports which are bought. But if the imported goods are essential e.g. oil, the actual supply of the domestic currency will increase in order to buy the oil.This will put downward pressure on the currency:

1. If demand for imports is inelastic, the total amount spent on imports will increase
2. If the demand for imports is elastic, then when their price rises (due to a fall in the value of the domestic currency) the total amount spent on them falls. (HL students See 4.6 Marshall Lerner condition Find webnote 417)

Supply: 3 Reasons for Supplying a Currency	M (there can be serious contractionary effects on the macro economy.) Remember that AD = C + I + G +(X-M)
1) **Spend**	Imports FDI (capital outflows- sometimes called

(domestic consumers demand more on foreign goods. They buy foreign currency with domestic currency = supply of domestic currency	capital flight) EU money transfers
2) Save (domestic firms households save abroad).	Saving in foreign country because interest rates are attractively high More interest = more income earned
3) Speculate (speculators supply more of the domestic currency)	Currency speculator **SELLS** domestic currency hoping to make a profit. See the value of the currency rise in the future. Look at George Soros story in webnote 324

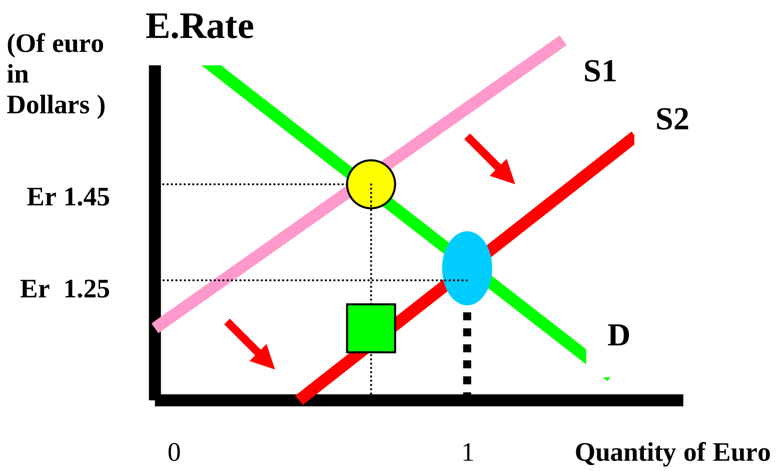
Supply determined by:

1. Spend **(on imports)** ↓

2. Save **(abroad)** ↓

3.Speculate **(abroad)** ↓

Fig 1: Exchange rate of Euro priced in US $



If there is a strong demand for imports (e.g. as the domestic incomes increase) this will tend to shift the supply curve for the domestic currency on foreign exchange markets
(S1 TO S2) driving the exchange rate down to er2.