***Webnote 322***

***Syllabus Items:***

***139 140 (HL) 141 142 (HL) 143 144***

***145,146***

**Syllabus weight : 3**

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

The supply of pounds will increase if:

1. Overseas interest rates increase so saving

abroad becomes more attractive

1. 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

1. 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 supply of pounds is downward sloping.

1. 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 4.7 Marshall Lerner condition

Find webnote 417)

**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 will increase in value

|  |  |
| --- | --- |
| Supply:  3 Reasons for Supplying a Currency | M |
| **Spend**  (domestic consumers demand more on foreign goods. They buy foreign currency with domestic currency = supply of domestic currency  **Syllabus weight = 3** | Imports  FDI (capital outflows- sometimes called capital flight)  EU money transfers  ***Webnote 321*** |
| **Save**  (domestic firms households save abroad). | Saving in foreign country because interest rates are attractively high  More interest = more income earned |
| **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 |

***Syllabus Items:***

***139 140 (HL) 141 142 (HL) 143 144***

***145,146***

**Supply** determined by:

1. **Save (abroad)**
2. ** Speculate (abroad)**
3. **Spend (on imports)**

**Fig 1: Exchange rate of Euro priced in US $**

**D**

**E.Rate**

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. 

**S1**

0 1 **Quantity of Euro**

**(Of euro in Dollars )**

**Er 1.45**

**Er 1.25**

**S2**