



What Are Exchange Rates?

- The Exchange Rate can be defined as:
“The price of one currency expressed in terms of another currency”

➤ For example:

If £1 = \$1.4 then you could buy 1 UK pound with 1.4 US Dollars

- The most commonly quoted are:

➤ £ / \$

➤ \$ / ¥

➤ £ / €

➤ € / ¥





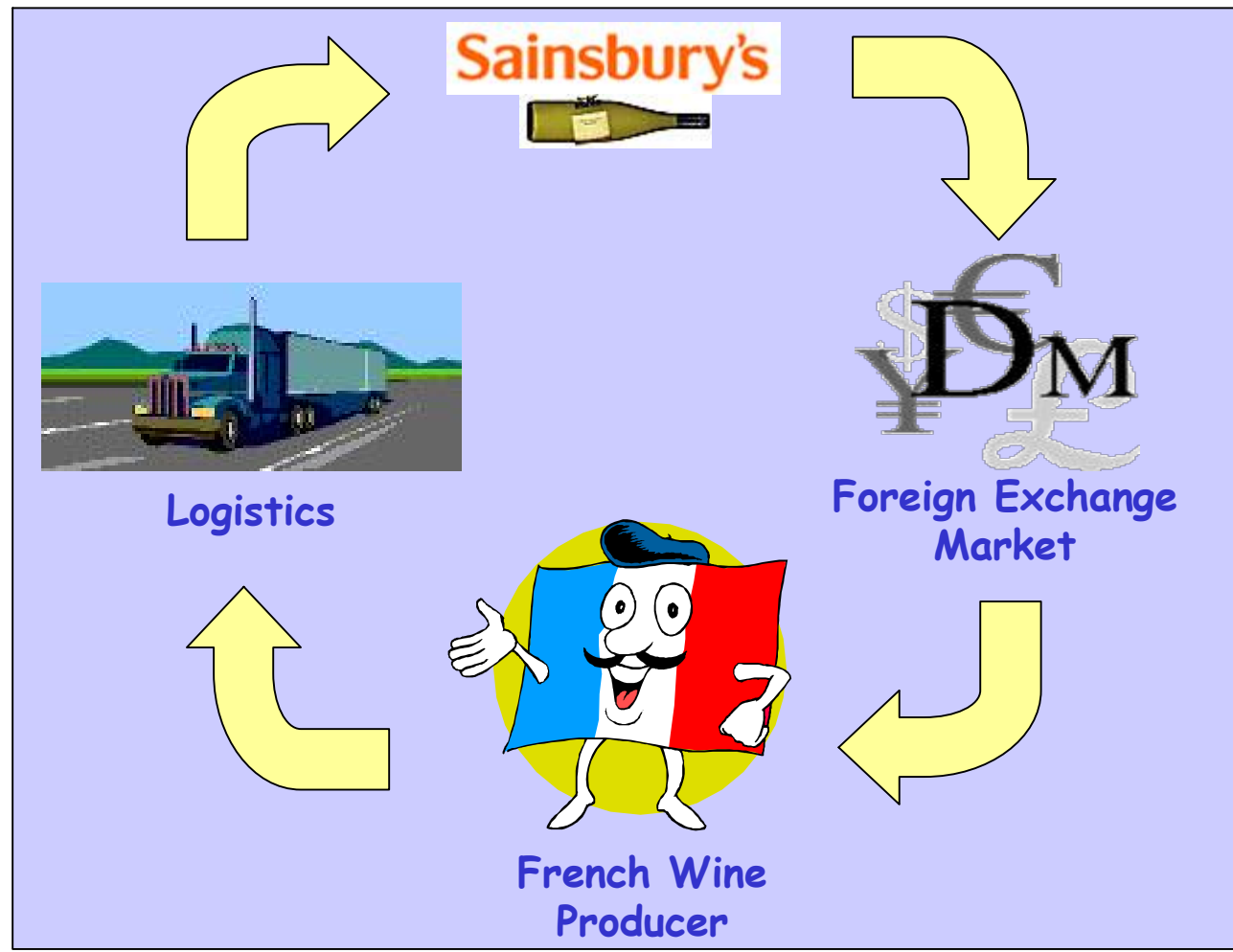
Why Do We Need Exchange Rates?

- No country can produce all the goods and services that it needs
- So they must buy products from other countries
- This means that countries **export** and **import**
 - **Imports** are products/services that are brought into the country, having been produced in another country
 - **Exports** are products/services that are produced in this country, but are sold to consumers in foreign countries
- However countries do not use the same currencies
- So we have to have a way of exchanging one currency for another
- This is done through the **Foreign Exchange Market**



How This Works

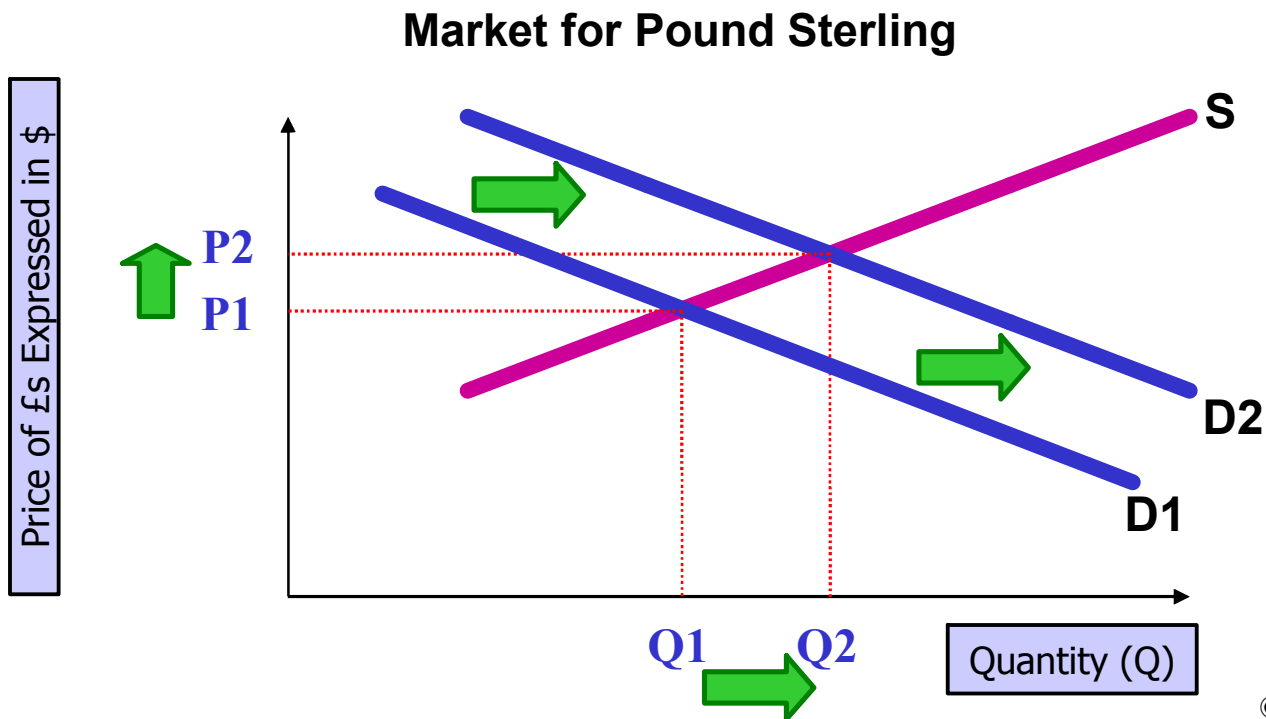
- Consider the following example of Sainsbury's importing French wine:





Changes In The Exchange Rate

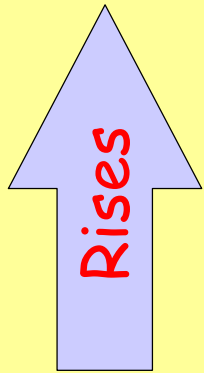
- The exchange rate of a currency is determined by the demand and supply for that currency
- E.g. if the demand for £ increases, then it will rise in value against other currencies:



Other Factors That Will Affect the Value of a Currency (1)

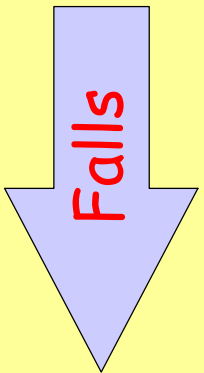


● Interest rates:



3. Demand for pounds increases, raising the price (exchange rate) of pounds
2. Foreign investors purchase pounds to invest in UK
1. UK becomes more attractive to foreign investors

Interest Rate



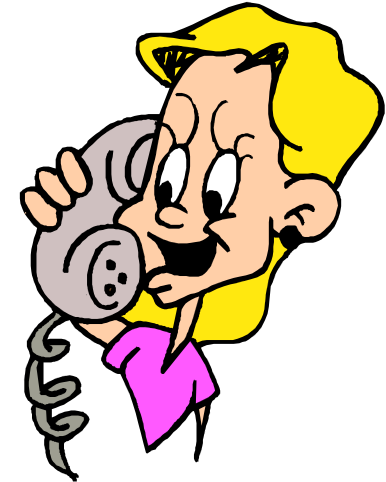
1. UK becomes less attractive to foreign investors
2. Foreign investors sell pounds to purchase other more lucrative currencies
3. Supply of pounds increases depressing the price (exchange rate)

Other Factors That Will Affect the Value of a Currency (2)



● Speculation

- Investors may decide to buy or sell a currency if they think that the value of it will change.
- It is possible to make a living out of doing this!



● Government Intervention

- The government may buy or sell currency to influence its value for economic reasons



The Effects of Exchange Rate Changes on Businesses



- Business that **import** and **export** can be greatly affected by changes in the value a currency
- There are two possible scenarios:
 - an **appreciation** of the exchange rate
 - where the value of the currency increases
 - a **depreciation** of the exchange rate
 - where the value of the currency falls
- The effect of these changes can be seen by considering the following example



The Effects of Exchange Rate Changes

- Changes in the exchange rate can have very big effects upon businesses:



Original Exchange Rate
£1 = \$1.50

British car sold in USA for:
\$30,000 ($£20,000 \times 1.5$)

American car sold in UK for:
£20,000 ($\$30,000 \div 1.5$)

New Exchange Rate
£1 = \$2





British car sold in USA for:
\$40,000 ($£20,000 \times 2$)

American car sold in UK for:
£15,000 ($\$30,000 \div 2$)

The Effects of Exchange Rate Changes on the Economy



- A change in the exchange rate can therefore have a significant effect on a country's economy

Exchange Rate	Demand for Exports	Demand for Imports
Appreciates	Decreases 	Increases 
Depreciates	Increases 	Decreases 

- Some businesses will suffer more than others, but all will be affected



The Effects of Exchange Rate Changes

- In order to remember the effect that a change in exchange rates has use the following acronym

**S
P
I
C
C
E
D**

trong

ound

mports

heap

xports

ear

