

Module 10

Factors that Determine the level of Exchange Rate

■ It is important to analyze the factors that determine whether or not the Exchange Rate of a country's currency rises or falls.

■ If or when the x^{US} rises, the U.S. currency is said to have **appreciated** (become stronger).

■ If/when the x^{US} falls, the U.S. currency is said to have **depreciated** (become weaker).

-- The factors that affect and determine the level of the country's x (i.e. that determine the rise and fall of a country's x) are:

(1) The size of the country's exports (X).

- Rising X would increase the DEMAND for the country's currency (by foreign buyers who need it to pay for the goods they bought from the country).
- This would raise the demand for the currency, leading to higher price (higher x), of that currency.
- Also, falling X would decrease the DEMAND for the country's currency (by foreign buyers who need it less to pay for less goods they bought from the country).
- This would decrease the demand for the currency, leading to lower price (lower x), of that currency.

(2) The size of the country's imports (M).

- Rising M would increase the SUPPLY of the country's currency (to obtain

foreign currency to pay for the imports of goods bought from those foreign countries).

- This raises the supply of the country's currency, leading to lower price, (lower x).
- Also, falling M would reduce the supply of the country's currency (as less foreign money is needed to pay for the less imports from the rest of the world).
- This decreases the supply of the country's currency, leading to higher price, (higher x).

(3) *The level of domestic interest rate (r).*

- The level of a country's domestic interest rate, r , and the gap between the r and that of other countries, impacts the country's x in a major way.

- Higher r of a country relative to that of other countries would mean higher returns on investment and investible funds in that country, relative to the rest of the world.
- Thus, higher r would lead to **higher capital inflow** into the country, from the rest of the world, leading to an INCREASE IN THE DEMAND for the country's currency and a rise in its x .
- Higher r would also lead to **lower capital outflow** from the country into the rest of the world, leading to a DECREASE IN THE SUPPLY of the country's currency, and a rise in x .

-- Conversely, lower r of a country relative to that of other countries, would mean lower returns on investment and investible funds in that country, relative to the rest of the world.

- Thus, lower r would lead to **higher capital outflow** from the country to the rest of the world, leading to an INCREASE IN THE SUPPLY of the country's currency, and a fall in x .
- Lower r would also lead to **lower capital inflow** into the country from the rest of the world, leading to a DECREASE IN THE DEMAND of the country's currency, and a weaker x .

Devaluation

- Devaluation is a special type of Fixed Exchange Rate policy.
- Devaluation means that the x is fixed, and maintained below its current market level, that is below the level that the free market (supply and demand) would yield.

- A country's currency may also be *overvalued*, if the x is fixed and maintained above its market value.
- Devaluation of a country's currency effectively raises the domestic prices of imports in the country, and lowers the prices of the country's exports in foreign markets.
- Apparently, the purpose of devaluation is to encourage higher export sales, and discourage imports, probably in an effort to correct a balance of trade deficit.
- This may succeed, however, only if the country's exports have elastic demand in foreign markets, while its imports also have elastic demand in the domestic market.

- As it is presently in global International Trade, often, the Central Banks of various countries frequently intervene in the international currency market to "regulate" the value of their currencies.
- For example, if their Exchange Rate goes under pressure to depreciate, they sell foreign exchange from their reserves, to buy (and thereby effectively raise the demand for) their own currency.
- This action provides support for the currency and stabilizes its x around the current level.
- If, on the other hand, a country's Exchange Rate gets too high, its Central Bank may buy foreign exchange to increase its reserve, thereby increasing the supply of its

currency, and reducing its price, the x , in the international money market.

- A country might occasionally allow its currency to depreciate because it might be lacking sufficient reserves of foreign exchange to support it.