Exchange Rates

AS Economics Presentation

2005

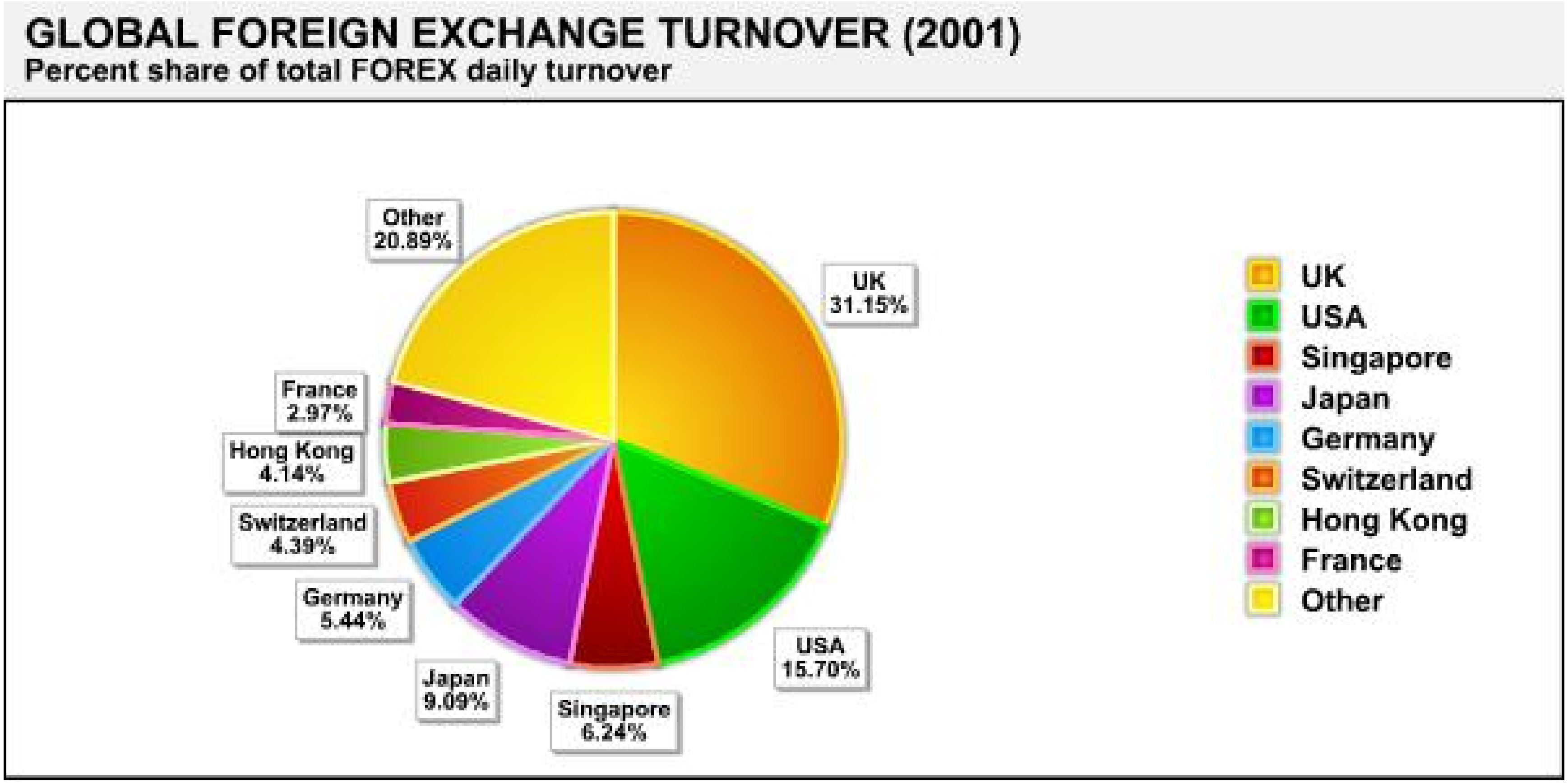
What is the Exchange Rate?

- The exchange rate is simply the value (or purchasing power) of a currency in terms of what it can buy of other currencies
- Valuations of each currency are determined in the foreign exchange markets
  - Global currency markets are open 24 hours per day
  - $1.2 trillion of currency are traded on the Foreign Exchange markets on an average day
  - That's roughly the equivalent of Italian GDP for one year!

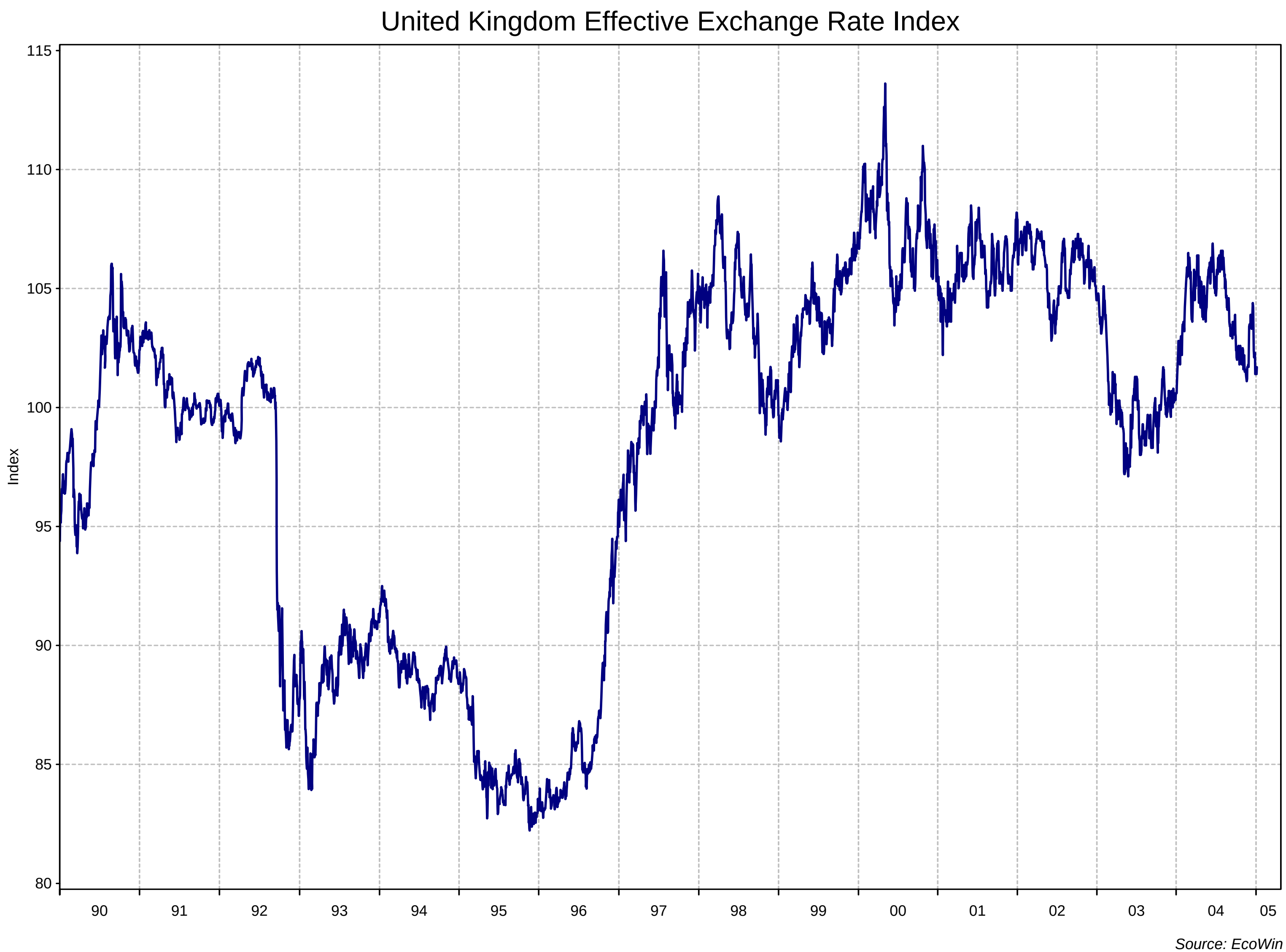
What is the Exchange Rate?

- London is the main centre of global currency dealing
- A large share of trading is purely speculative – i.e. currency dealers seeking to make a profit!
- Other currency flows are the result of
  - (a) International trade flows in goods and services
  - (b) Capital flows (e.g. net flows of foreign direct investment and speculative flows of money between countries into banks etc)

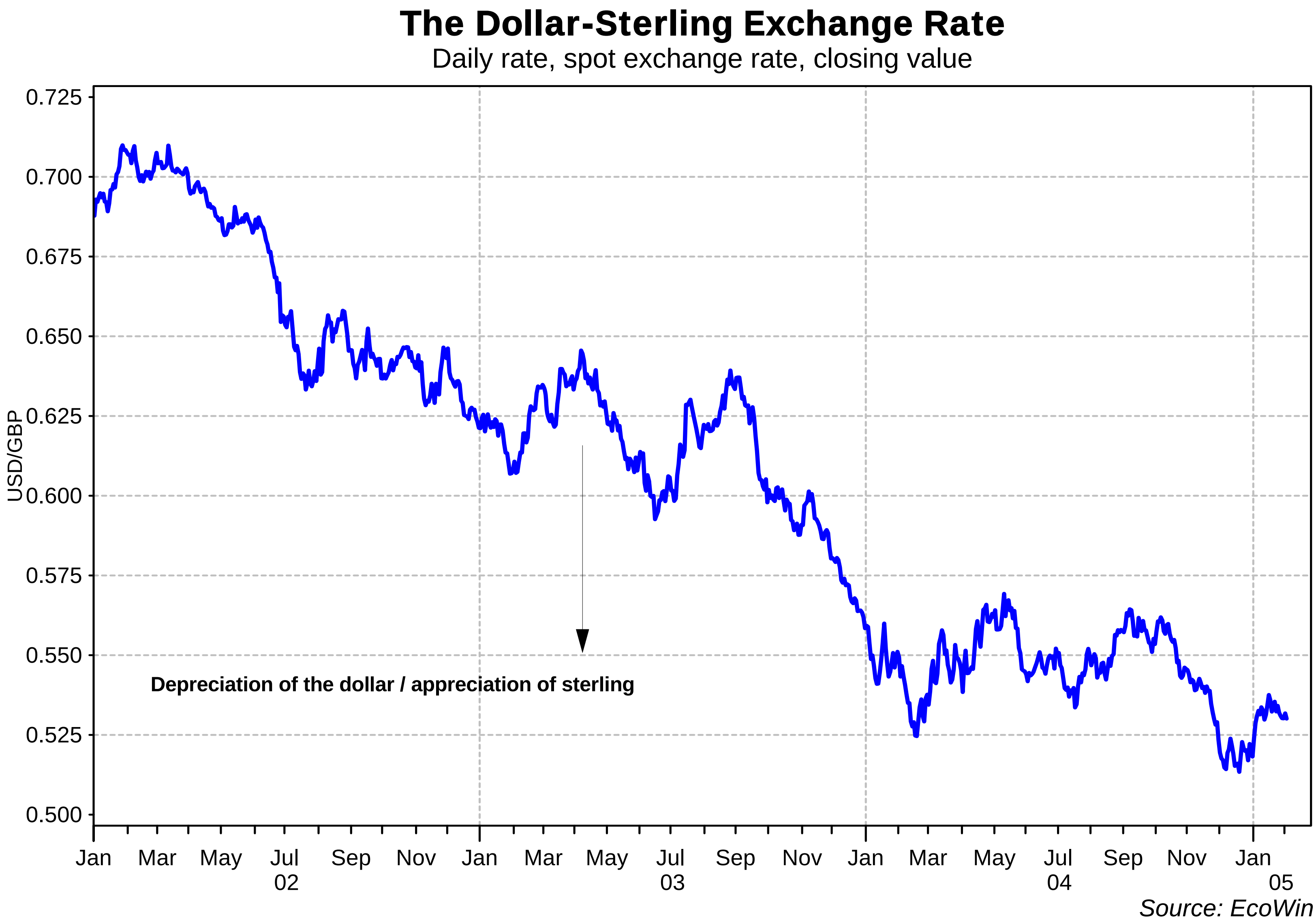
Global Currency Trading Volumes



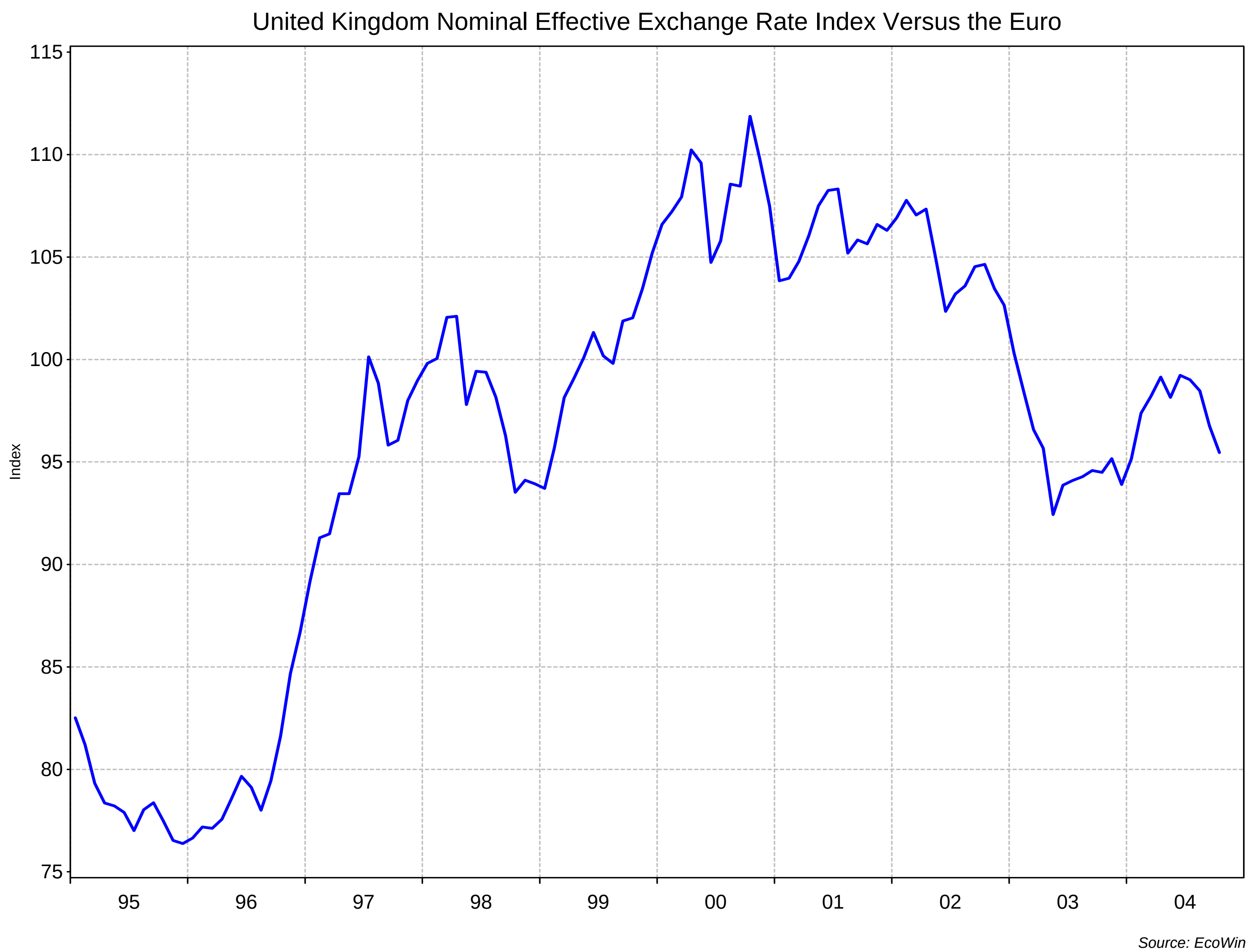
Trends in the sterling exchange rate



Sterling against the Dollar



Sterling against the Euro



Measuring the Exchange Rate

- Bi-lateral exchange rate
  - The exchange rate between two distinct currencies
    - £/ $ (cable rate)
    - $ / YEN
    - Sterling / Euro
    - Euro / Yen

Measuring the Exchange Rate

- Exchange rate index (EER)
  - Sterling's average value against a basket of currencies
    - Weighted against the proportion of trade that the UK does with each country
    - Heavily weighted currencies are the Euro and the dollar
    - Gives an indication of the overall strength or weakness of the UK currency in international markets

How A Fall in Sterling Affects Inflation?

- (1) Weaker pound drives up import prices
  - Higher import prices drive up firms’ costs
  - But these are only one element (wages more important)
- (2) Higher import prices feed directly into retail price index
  - E.g. prices of imported computers, cars, household furniture

How A Fall in Sterling Affects Inflation?

- (3) Weaker pound leads to stronger aggregate demand
  - E.g. faster growth of exports and a slower growth of imports
  - Stronger aggregate demand can increase inflationary pressure – depending on the amount of spare capacity in the economy
  - Consensus estimate - in the long run, a 10% depreciation in the exchange rate eventually leads to a 10% increase in the domestic price level

Advantages of a Strong Pound

- A high pounds leads to lower import prices – this boosts the real living standards of consumers at least in the short run
- Cheaper to import raw materials, components and capital inputs – good news for businesses that rely on imported components or who are wishing to increase their investment of new technology from overseas countries

Advantages of a Strong Pound (2)

- A strong exchange rate helps to control inflation because domestic producers face stiffer international competition from cheaper imports and will look to cut their costs accordingly
- An increase in the real purchasing power of UK consumers e.g. when travelling abroad

Disadvantages of a Strong Pound

- Cheaper imports leads to rising import penetration and a larger trade deficit
- Exporters lose price competitiveness and market share – this can damage profits and employment in some sectors.
- If exports fall, this has a negative impact on economic growth through the multiplier effect
  - Some regions of the economy are affected by this more than others
  - In the North east for example, manufacturing industry accounts for over 28% of regional GDP whereas the percentage for the UK as a whole is just 19%.

Exchange Rate & Balance of Trade