

Exchange Rates

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Exchange Rates

- Why do we buy foreign currency?
- The primary reason is so we can buy goods, services, and financial assets that originate in the foreign country
- Ex: German Chocolates, Ex: Toyota
- Most of the demand for currency is derived demand - demand that comes from your demand for that countries stuff
- Some of the demand is people holding foreign currency as an asset
- **Exchange Rate** - The price of a unit of foreign currency
- There are two ways to express exchange rates - how many dollars to buy foreign currency, and how much foreign currency to buy a dollar Ex: website

Currency Market

- If we have exchange rates as how many dollars to buy foreign currency then we can use supply and demand to evaluate the currency market
- In the currency market the good is foreign currency (Euros)
- The price is the exchange rate (expressed in terms of dollars for a unit of foreign currency)
- Using supply and demand we can find the equilibrium quantity of foreign currency and the exchange rate Ex: graph
- The supply of foreign currency is assumed fix (just like in money market)
- **Dollar Appreciation** - decrease in the number of dollars per unit of foreign currency, the exchange rate falls, each dollar is worth more
- **Dollar Depreciation** - increase in the number of dollars per unit of foreign currency, the exchange rate rises, each dollar is worth less