The Foreign Exchange Market

Within an economy prices are stated in the domestic currency. For example, in the United States, prices are stated in dollars and in Europe prices are stated in euros. Buyers use the domestic currency to purchase domestic goods. However, when goods are purchased from another country, they must be paid for in that country's domestic currency. Exporters are paid in the domestic currencies so they can spend it domestically. As a result, international trade requires that currencies also be traded. Currencies are traded in *foreign exchange markets.* The equilibrium price at which currencies are traded is called the *exchange rate*. An exchange rate is the rate at which the currency of one country is exchanged for the currency of another.

Table 7-3.1 shows the exchange rates for selected countries for May and August of the same year.

Table 7-3.1
Exchange Rates

	Cost of foreign currency in U.S. dollars (U.S. dollars/foreign currency)		Cost of U.S. dollar in foreign currency (foreign currency/U.S. dollars)	
	May	August	May	August
British pound	1.4	1.8	0.71	0.56
Canadian dollar	0.64	0.63	1.5625	1.5873
European euro	0.87	0.91	1.149	1.099
Swedish krona	0.094	0.093	10.638	10.753
Japanese yen	0.0083	0.0090	120.482	111.111
Mexican peso	0.1101	0.1502	9.083	6.6558

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Use the data in the table to calculate the cost of the following products in U.S. dollars. To solve, divide the cost of the product in the foreign currency by the cost of the U.S. dollar in the foreign currency. Indicate whether the dollar has appreciated or depreciated between May and August.

	May	August	Appreciated or Depreciated
1. A dinner for two that costs 500 Mexican pesos			
2. A hotel room that costs 30,000 Japanese yen			
3. A BMW that costs 85,000 euros in Germany			
4. A pound of Swedish meatballs that costs 30 kronor			
5. A pair of pants that costs 72 pounds in London			
6. A leather jacket that costs 1,800 Canadian dollars			

When Americans buy foreign goods, U.S. dollars are supplied in the foreign exchange market and the foreign currency is demanded. When foreigners buy U.S. goods, the foreign currency is supplied in foreign exchange markets and the U.S. dollar is demanded. A foreign exchange market determines the equilibrium exchange rate (price) and quantity of currency exchanged using the supply and demand curves for a currency.

An increase in the exchange rate for a currency (which can be caused by an increase in demand or a decrease in supply) is called *appreciation* of that currency. When a currency appreciates, it is said to have strengthened. For example, if the exchange rate increases in the market for dollars, it means that it takes more of the foreign currency to purchase a dollar. This means that a dollar can buy more of the foreign currency. A decrease in the exchange rate for a currency (which can be caused by a decrease in demand or an increase in supply) is called *depreciation* of that currency. When a currency depreciates, it is said to have weakened. For example, if the exchange rate decreases in the market for dollars, it means that it takes less of the foreign currency to purchase a dollar. This means it takes more dollars to buy the foreign currency.

Appreciation or depreciation of a currency changes the price of imports and exports. When a country's currency appreciates, it is more expensive for foreigners to buy the country's exports and it is cheaper for the country to buy imports. When a country's currency depreciates, it is cheaper for foreigners to buy the country's exports and it is more expensive for the country to buy imports. Appreciation and depreciation of a currency will affect the economy because they affect net exports.

Consider the following situations. In each case, an underlying event causes a change in foreign exchange markets. Graph the effect on the equilibrium exchange rate and currency exchanged in the foreign exchange markets as shown in the example.

! ***Student Alert:*** **Pay close attention to correct labeling on foreign exchange market graphs!**

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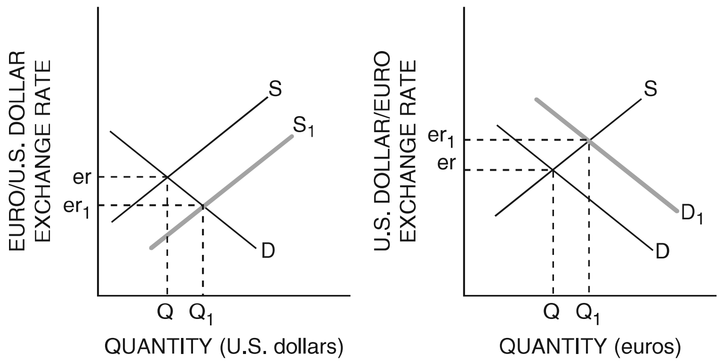
EXAMPLE: The prices of U.S. goods rise relative to the prices of German goods.

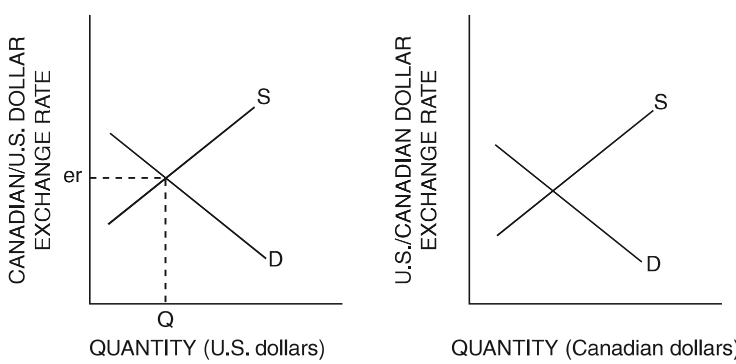
Figure 7-3.1
Prices of U.S. Goods Increase



Rationale: *Americans will demand the less expensive German goods. To purchase the German goods, they need euros, so the demand for euros increases (shifts to the right). To buy euros, the Americans will supply U.S. dollars to the foreign exchange market, so the supply of U.S. dollars shifts to the right. The U.S. dollar depreciates (the exchange rate decreases). The euro appreciates (the exchange rate increases).*

7. Real interest rates in the United States rise faster than real interest rates in Canada.

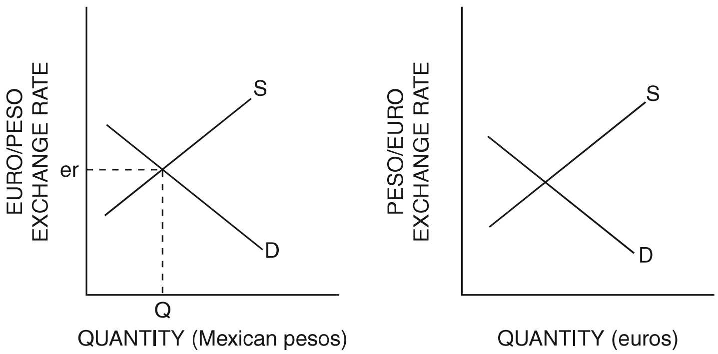
Figure 7-3.2
Real Interest Rates in the United States Increase



Rationale:

8. French tourists flock to Mexico's beaches.

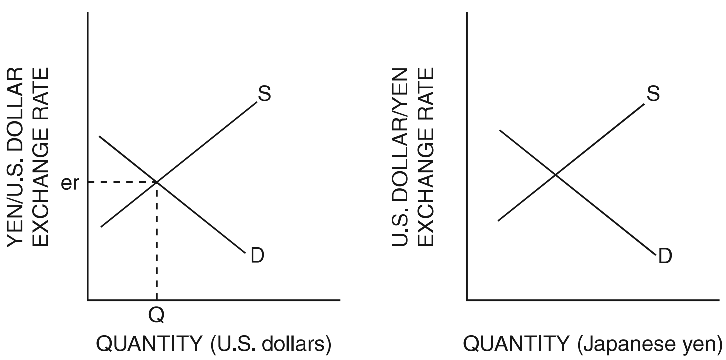
Figure 7-3.3
French Tourists Visit Mexico



Rationale:

9. Japanese video games become popular with U.S. children.

Figure 7-3.4
U.S. Children Want Videos Produced in Japan



Rationale: