

Exchange rates

What determines exchange rate?

The exchange rate is the value of the pound in relation to that of other currencies. It is determined by supply and demand. The demand for pounds comes from:

- Foreign investors (“hot money”) moving into the UK.
- Purchase of exports (including visitors on holiday in the UK).
- Speculators who believe the pound will rise in value.
- Government selling foreign currency reserves to buy pounds.
- UK investors moving funds into the domestic economy from abroad.

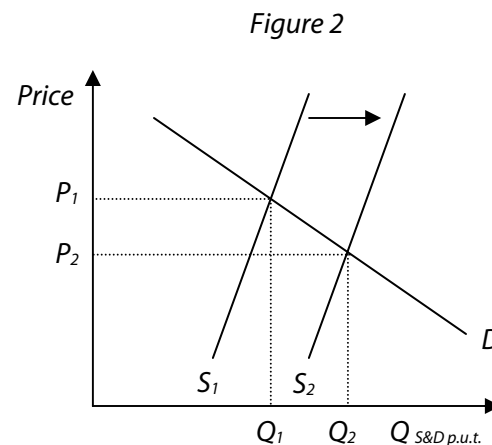
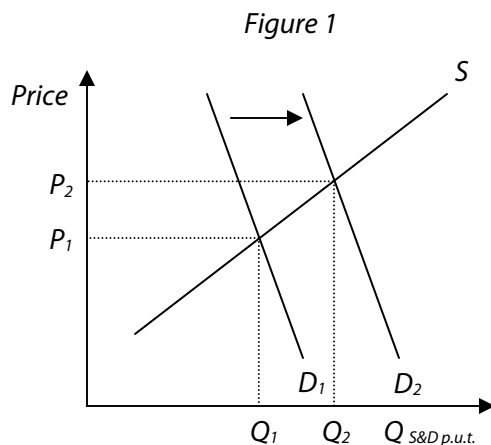
... and the supply for pounds comes from:

- UK citizens/firms importing goods (including buying overseas holidays).
- Speculators who expect the value of the pound to decrease.
- Government selling pounds to buy foreign currency for reserves.
- Foreign investors withdrawing funds from the UK.
- UK investors moving funds abroad.

What tools can be used to control the exchange rate and how do they work?

Interest rate

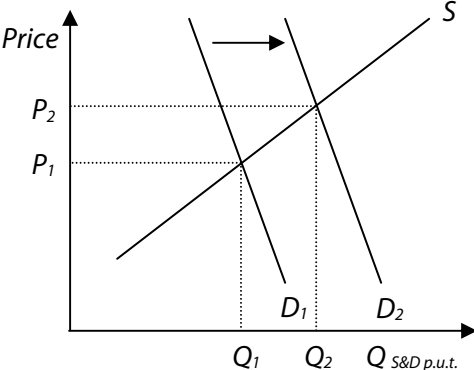
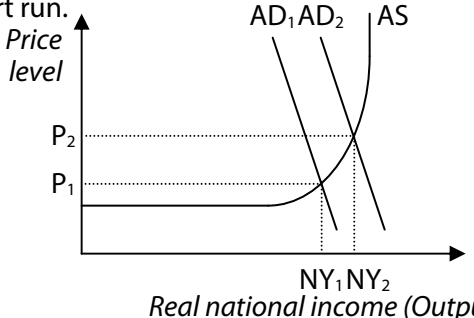
If this is higher than other economies then individuals with hot money may move their money into the UK. This will cause an increase in demand for pounds (*Figure 1*). This will cause a shift from D_1 to D_2 , an increase in quantity demanded per unit of time from Q_1 to Q_2 which results in an increase in price from P_1 to P_2 . This is referred to as appreciation of the pound. If the interest rate is lower than in other economies the opposite will happen (*Figure 2*). Funds will flow out of the UK economy and cause an increase in supply from S_1 to S_2 , an increase in quantity demanded per unit of time from Q_1 to Q_2 which results in a decrease in price from P_1 to P_2 . This drop in the price of the pound is called depreciation.



Government spending

The only control the government now has on exchange rates is through exchanging its foreign currency reserves for pounds, or selling pounds for its reserves. This has a very small effect and is not sustainable (such as during the ERM period) and due to the vast amount of currency traded daily any effect caused by the government trading its reserves would be minimal.

Using the exchange rate to achieve macroeconomic objectives

Macroeconomic objective	Change to exchange rate	How would it work? Any problems?
<p>Low and stable inflation</p> <p><i>Aim to eliminate imported inflation if lots of raw materials, goods and services are imported from abroad</i></p>	<p>Appreciate.</p>	<p>By increasing the base rate of interest relative to other economies and the government selling its foreign currency reserves to buy pounds the demand for pounds will increase. This will cause appreciation which will make imports less expensive and as the UK is very reliant on imports this will ease the pressure of inflation.</p>  <p>The effect depends on the exchange rate and proportion of consumer goods that are imported.</p>
<p>Low unemployment and sustainable growth</p>	<p>Depreciate.</p>	<p>By decreasing the rate of interest or the government increasing its foreign currency reserves UK exports become cheaper for overseas citizens, which causes an increase in demand for UK exports which will utilise more resources in the UK economy which should cause a shift in aggregate demand a lower unemployment in the short run.</p>  <p>This will cause the problems associated with inflation as the economy nears its productive capacity which causes inflation as shown above and the increase in the</p>

		price of exports causes imported inflation as UK consumers now with an increased national income buy more luxury imported goods. In the long run new firms should enter the market in the UK to provide the goods and services which are expensive imported luxuries. This should cause long run sustainable growth.
Balance of payments equilibrium <i>UK – reduce the deficit</i> <i>Japan – reduce the surplus</i>	Depreciate for the UK, appreciate for Japan.	<p>For the UK imports would become more expensive and exports more competitive. This will lead to problems of inflation in the short run as demand for imports is very inelastic but should encourage new UK based firms to enter the market to supply to the domestic economy.</p> <p>For Japan imports become cheaper and more competitive than home produced goods and services so imports increase and exports become less competitive so exports decrease.</p> <p>For both economies there will be a time lag whilst firms enter the market for the UK and leave the market or adapt in Japan. In the UK there will also be the short run problem of higher inflation.</p>

The two tools that the government can theoretically use to bring about changes in the exchange rate are interest rates and government spending. However, in the UK the government does not control the rate of interest. This is the job of the Bank of England (whose main goal is price stability), and the government adjusting its foreign currency reserves is politically unpopular. The UK is officially a free floating currency, meaning the exchange rate is governed entirely by supply and demand. Use of government foreign currency reserves to distort the exchange rate the market sets would be regarded and 'dirty floating.'

There are three ways a currency can be exchanged on currency markets. Either free floating, like the UK pound where the rate is determined entirely by supply and demand, managed floating where a target is aimed for, such as the UK economy during the ERM in preparation for the EMU. For those economies that entered the Euro the exchange rates were irrevocably fixed, referred to as a fixed exchange rate.