

[Frequently Asked Questions]

Factors Affecting Exchange Rates Part - 1	
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Unit – 4 Factors Affecting Exchange Rates and Exposures

Lecture No. & Title:

Lecture – 1 Factors Affecting Exchange Rates Part-1

Frequently Asked Questions

Q1. Explain the demand for currency

A1. The demand for currencies is derived from the demand for a country's exports, and from speculators looking to make a profit on changes in currency values.

For example:

For Americans, British goods are less expensive when the pound is cheaper and the dollar is stronger. At depreciated values for the pound, Americans will switch from American-made or thirdparty suppliers of goods and services to British suppliers. Before they can purchase goods made in Britain, they must exchange dollars for British pounds. Consequently, the increased demand for British goods is simultaneously an increase in the quantity of British pounds demanded.

Q2. Explain the supply of currency

A2. The supply of a currency is determined by the domestic demand for imports from abroad. For example, when the British imports cars from USA it must pay in dollar, and to buy dollar it must sell (supply) pounds. The more it imports the greater the supply of pounds onto the foreign exchange market. A large proportion of short-term trade in currencies is by dealers who work for financial institutions. The London foreign exchange market is the World's single largest international exchange market.

Continuing the previous example the supply curve would slope upward because British firms and consumers are willing to buy a greater quantity of American goods as the dollar becomes cheaper (i.e. they receive more dollars per pound). Before British customers can buy American goods, however, they must first convert pounds into dollars, so the increase in the quantity of American goods demanded is simultaneously an increase in the quantity of foreign currency supplied to the United States.

Q3. Write a brief note on Exchange rates.

A3. The equilibrium exchange rate is the rate which equates demand and supply for a particular currency against another currency.



Example

If we assume the UK and France both produce goods that the other wants, they will wish to trade with each other. However, French producers require payment in Euros and the British producers require payments in pounds Sterling. Both need payment in their own *local* currency so that they can pay their own production costs in their local currency. The foreign exchange market enables both French and British producers to exchange currencies so that trades can take place. The market will create an equilibrium exchange rate for each currency, which will exist where demand and supply of currencies equates.

Q4. List down the factors that lead to Changes in exchange rates

A4. A variety of actors cause currencies to experience changes in supply and demand:

- Companies that export and import,
- Foreign investors and banks,
- Speculators who wish to engage in market activity,
- And central banks that control the movement of interest rates.

Q5. Explain how Exporting and Importing Companies acts as a factor leading to changing exchange rates.

A5. Large multinational corporations influence the foreign exchange market as they purchase and sell goods and materials between different countries.

The first group that has influence in the foreign exchange markets is typified by large, multinational corporations. Imagine a New York City firm exports its products to a German company. The business transaction will be settled in dollars so the American firm obtains revenue in its own currency and can pay its employees' salaries in dollars.

To facilitate the transaction, the German firm needs to convert some of its capital from euros to dollars on the foreign exchange market. The supply of euros increases leading to an appreciation of the dollar and depreciation of the euro. It can also be said that the German firm increases the demand for dollars, again causing the dollar to appreciate in comparison to the euro. This transaction would have to be for a very large contract in order for the exchange rate to actually move a pip up or down.

If the payment by the German company is coming 6 months later, it introduces the risk that the amount of dollars they would receive for a certain amount of euros today will not be the same in 6 months time. A company may want to limit, or hedge, this exchange rate risk by immediately converting their euro into dollars, or by purchasing forward contracts in the foreign exchange market. A forward contract is a contract to convert euros into dollars at a future date at a set price.

Importing companies affect the demand of a currency as well. For example, an American retailer features Japanese furnishings and pays its suppliers in Japanese yen. If consumers like these products then they will indirectly contribute to an increase in demand for the yen as the American retailer will have to buy more merchandise from Japan. As the retailer purchases the yen and sells the dollar on the exchange market, the yen appreciates.

Q6. Explain how Foreign Investment Flows acts as a factor leading to change in exchange rates.

A6. Foreign investment has many aspects, having to do with goods, services, stocks, bonds, or property. Suppose a Canadian company wants to open a factory in America. In order to cover the costs of the land, labor and capital the firm will need dollars. Suppose the company holds most of its reserves in Canadian dollars. It must sell some of its Canadian dollars to buy US dollars. The supply of Canadian dollars on the foreign exchange market will increase and the supply of US dollars will decrease, which causes the US dollar to appreciate against the Canadian dollar. On the flip side, foreign investors are also increasing or decreasing the

demand for the currency of the country in which they are interested in investing.

Q7. Explain how Banks acts as a factor leading to change in exchange rates.

A7. For a long time the foreign exchange market has been associated with the term "interbank" market. This term was employed to capture the nature of the foreign exchange market when it predominantly dealt with banks. Banks included central banks, investment banks and commercial banks.

Examples of central banks include the Federal Reserve Bank of the United States or the European Central Bank.

Investment banks include those of Goldman Sachs, JP Morgan, and Bank of America.

Today, banks are not the only participants within the foreign exchange market. With the onset of technology and the growing ease of accessibility to market activity, there has been an increase in many non bank participants such as individuals.

Q8. Explain how Speculators - Investment Management Firms, Hedge funds, and Retail Traders acts as a factor leading to change in exchange rates.

A8. Many financial institutions use currency exchange as a method to generate income. There are also many individuals who try to do the same thing. The currency markets move in one direction only when many investors act together. An individual investor cannot move the exchange rate of a currency but many traders, investment funds, and banks may collectively move it.

If speculating traders think the Japanese Yen is going to weaken in the near future due to poor economic data or a change in interest rate policy, then they sell the yen on the foreign exchange market relative to another stronger currency. The supply of yen will increase and cause the currency to depreciate. If many investors feel that a particular currency will depreciate in the near future, their collective selling of that currency will move its price down. Similarly, if speculators feel that a currency is going to appreciate in the near future then they will buy that currency today and cause it to experience a higher demand which causes its price to go up. Investors help materialize their predictions by acting in a herd mentality, and in some peoples eyes bring about a self fulfilling prophecy.

Q9. Explain the two exchange rates: Floating vs. Fixed Exchange Rates

A9. There are two types of exchange rate systems: floating or fixed. A floating exchange rate is one in which a currency's value is determined by market forces. A fixed exchange rate matches, "pegs", the value of the currency to: one currency, several currencies or even to a fixed amount of a commodity.

Floating Exchange Rates Prior to 1971's breakdown of the Bretton Woods Agreement (a fixed exchange rate system revolving around the US Dollar and gold), most currencies were pegged. Today, the current international financial system squares most of the currencies of the world against one another in a free market. Floating exchange rates are preferable to fixed ones since floating rates are reflective of market movement and the principles of supply and demand and limit imbalances in the international financial system. Fixed exchange rates grant more control to central banks (who may or may not be independent of the government) to set a currency's value, and during times of volatility are preferred for their greater stability. Many developing countries use fixed exchange rates in order to evade market abuse.

In extreme situations such as political unrest, terrorist attacks or natural disasters a country's currency may experience a period of heavy selling that causes it to depreciate in value. The country's central bank may intervene in order to restore the value of the currency. A central bank regime that routinely intervenes would use the term "managed float". Sometimes, the central bank may set upper and lower bounds known as price ceilings and floors, respectively, and intervene whenever those bounds are reached.

Q10. What is the 'J-Curve Effect'

A10. The J-curve effect is a type of diagram where the curve falls at the outset and eventually rises to a point higher than the starting point, suggesting the letter J. While a J-curve can apply to data in a variety of fields, such as medicine and political science, the J-curve effect is most notable in both economics and private equity funds; after a certain policy or investment is made, an initial loss is followed by a significant gain.

Q11. How J curve effect works? Explain with an Example.

A11. The J-curve effect is a phenomenon in which a period of negative or unfavorable returns is followed by a gradual recovery that stabilizes at a higher level than before the decline. The progression of this phenomenon appears as a "J" shape on a time-series graph.



The J-curve effect is often seen in a country's balance of trade and equity fund returns.