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Exchange Rates

Definition: price of one currency in terms of another.

I. In What Forms are Exchange Rates Reported?

Yesterday the exchange rate for the euro was:

.872 US dollars per euro or 1.1460 euros per US dollar

Spot Rate (exchange rate today) vs. Forward Rate (contract entered into today for exchange at a later date).

A. Bilateral Nominal Rates: rates such as those listed above

B. Multilateral (Trade-Weighted) Rates: average exchange rates of one currency across other currencies, with each exchange rate given a weight corresponding to the share of trade with each particular nation.

C. Real Rates: exchange rates corrected for inflation (in the home country and foreign country).

D. Forward Rates: international traders make contracts to reduce uncertainty. These contracts "lock in" an exchange rate (often called Hedging). Forward markets are also used for speculative purposes, where people take risks with currency trading in order to make money.

II. What Determines Exchange Rates?

A. Markets

Very efficient markets, prices are very similar in different markets across the world. (Inefficient markets might cause the price of pounds in Tokyo to differ vastly from the price of pounds in New York).

B. Governments/Central Banks

Governments and Central Banks may intervene (buy and sell currencies in the markets themselves) to influence the exchange rate. E.g. to peg exchange rates (fix them), central bank intervenes in the market.

III. Theories of Exchange Rates

A. Purchasing Power Parity (PPP): if PPP holds, each currency has the same purchasing power within its borders.

Definition: for bilateral exchange rate between two countries A and B, PPP says that:

A's rate of depreciation = A's rate of inflation minus B's rate of inflation.

B. Asset Theory: exchange rates adjust so that assets yield the same return in different places. Therefore, exchange rates must be whatever they are expected to be.

C. Supply and Demand: a normal supply and demand diagram, this time featuring the supply and demand for a particular currency. Shifts in supply or demand, will influence the market price (exchange rate) of the currency.