Understanding the Foreign Exchange (FOREX) Market

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Today’s menu:

i) Differentiate between fixed and floating exchange rates.

ii) Understand why the exchange rate changes.

iii) Understand how the exchange rate is effected by inflation, income, and interest.

Key Definitions

Exchange Rate: The price of a foreign currency in terms of a nation’s own currency. For example, if it costs $1.50 Canadian to buy one American dollar, then the exchange rate is $0.67. (Think of this as a response to an event: what you get / what you give.)

Flexible (Floating) Exchange Rate: An exchange rate that is determined by the market forces (supply of, and demand for, the currency).

Fixed (Pegged) Exchange Rate: A currency whose value is set in relation to some other currency. The government must therefore intervene in the market, buying and selling the currency so as to manipulate its value. (China has $3.2 trillion US as of Dec. 2011.)

Foreign Exchange Market: The market in which the currency of one country is exchanged for the currency of another. Not an autonomous physical entity, but rather a network of thousands of importers, exporters, banks, and foreign exchange brokers.

What comprises the demand for Canadian Dollars?

The key to understanding the foreign exchange market is to realize that foreign parties who wish to:

i) purchase a country’s goods or services,

ii) invest in a country’s stock market, or

iii) enjoy higher interest rates offered within a country

...will FIRST have to purchase that country’s currency!

Naturally, this will shift the demand for that currency up.

Conversely, if current holders of a country’s currency wish to buy other currencies, then the market supply of that country currency will increase as holders of that currency go about trading that currency for other currencies. Naturally, an increase in supply reduces the currency’s value.

Calculating the Exchange Rate

The exchange rate is calculated by:

\[
\frac{\text{currency measured against}}{\text{currency measured}}
\]

For example, if it costs 0.32 Euros to buy 1 Peso:

\[
\text{Peso} \quad \frac{0.32}{\text{Euro}} = 3.125 \text{ Pesos}
\]

Thus, the value of the Euro in terms of Pesos is 3.125 Pesos.
The Exchange Rate

The exchange rate plays a particularly important role in the Canadian economy because, compared to other countries, imports and exports represent a relatively large part of Canada's economic activity.

<table>
<thead>
<tr>
<th>Quantity of CDN Dollars</th>
<th>Quantity of USD Dollars</th>
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<tr>
<td>World</td>
<td>Canada</td>
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Demand for $CDN comes from holders of other currencies seeking to buy $CDN.

Supply of $CDN comes from holders of USD seeking to buy other currencies.

Let's not confuse apples with oranges!

Demand and supply are two completely separate issues, but if we're not careful we can confuse them. Sometimes we think that an increase in demand will "deplete" supply.

Demand for apples comes from apple eaters!

Supply of apples comes from orchards.

Analyzing the Exchange Rate

Increasing the supply of the Canadian dollar

More holders of Canadian dollars (usually Canadians) buying other currencies on the FOREX market will increase the supply of Canadian dollar and decrease the value of the dollar.

Decreasing the supply of the Canadian dollar

Fewer holders of Canadian dollars (usually Canadians) buying other currencies on the FOREX market will decrease the supply of Canadian dollar and increase the value of the dollar.

Increasing the demand for the Canadian dollar

More holders of other currencies (usually foreign entities) buying Canadian dollars on the FOREX market will increase the demand for the Canadian dollar and increase the value of the dollar.

Decreasing the demand for the Canadian dollar

Fewer holders of other currencies (usually foreign entities) buying Canadian dollars on the FOREX market will decrease the demand for the Canadian dollar and decrease the value of the dollar.
The Exchange Rate

Inflation and the Exchange Rate

High inflation is unattractive to foreign buyers, as the price of goods or service will be more expensive. Also, the purchasing power of the currency is dropping – so it might not be able to buy tomorrow what it could buy today! Thus, demand drops.

In addition, the expense of Canadian products will cause Canadians to seek cheaper foreign products. Thus, the supply of Canadian funds on the world market will increase.

The Exchange Rate

Income, Balance of Payments and the Exchange Rate

If Canadian income increases, then Canadians will demand more imports. (Especially while their dollar is powerful enough to buy valuable imports.) Thus, the supply of Canadian dollars on the world market will increase.

However, once the supply of Canadian dollars increases, the value of the looney will drop!

Canadians will then buy less imports, as they will receive less for their money.

The Exchange Rate

Interest rates and the Exchange Rate

High interest on Canadian securities is attractive to foreign investors, while low interest is unattractive.

Thus, if the Bank of Canada lowers interest rates to implement an expansionary policy, the demand for Canadian securities (and the dollar) will drop.

In addition, the selling off of Canadian securities (as investors search for high yields elsewhere) will cause the supply of the looney to increase.