NO PREP

Understanding Exchange Rates and Currency Markets

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Name: Period: Date:

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How Exchange Rates Work

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How Exchange Rates Work

An exchange rate is the price of one currency in terms of another. For example, 1 USD = 0.90 EUR. Rates fluctuate based on supply and demand in the foreign exchange (Forex) market, the largest financial market globally, with daily trading exceeding $6 trillion. Participants include banks, corporations, governments, and speculators. Exchange rates determine how much foreigners pay for a country's exports and how expensive imports become, directly affecting trade balances, inflation, and travel costs. Two main regimes exist: floating rates, determined by market forces, and fixed rates, pegged by governments to another currency or basket.

Determinants of Currency Value

Several factors influence exchange rates. Interest rate differentials are paramount: higher rates attract foreign capital seeking better returns, appreciating the currency. Inflation gaps can erode purchasing power, leading to depreciation. Economic growth, measured by GDP, signals investment opportunities, boosting demand for that currency. Political stability and policy credibility matter: safe-haven currencies (e.g., USD, CHF, JPY) often strengthen during global turmoil. Balance of payments positions, whether surplus or deficit, reflect net capital flows and trade competitiveness, further swaying rates.

Impacts on Trade and Prices

When a currency appreciates, exports become pricier for foreigners, potentially reducing demand, while imports become cheaper, benefiting consumers. For example, if the USD strengthens from 1 USD = 100 JPY to 1 USD = 110 JPY, Japanese imports cost more yen, but Americans find Japanese electronics cheaper.

Conversely, depreciation boosts export competitiveness but can stoke inflation by raising import costs. Tourism and remittances also feel the impact: a weaker currency improves inbound tourist spending power but reduces the home-currency value of overseas earnings.

Speculation and Intervention

Speculators seek to profit from anticipated rate moves, adding liquidity but sometimes amplifying volatility. Central banks may intervene—buying or selling currencies—to smooth excessive swings or to maintain targets under a fixed regime. For instance, the Swiss National Bank once capped the franc at 1.20 CHF per euro, defending the level through massive euro purchases. Such interventions can deplete reserves if sustained, underscoring the delicate balance between market forces and policy goals.

Key Information: Table 1: Key Drivers of Exchange Rates

Driver	Effect on Currency
Higher Interest Rates	Appreciation (attracts foreign capital)
Higher Inflation	Depreciation (reduces purchasing power)
Strong GDP Growth	Appreciation (signals investment opportunities)
Political Uncertainty	Depreciation (increases risk premium)
Trade Surplus	Appreciation (foreign demand for currency to pay for exports)

Case Study Excerpt: The Euro's Rollercoaster (2014–2017)

Between mid-2014 and early 2015, the euro (EUR) plunged from 1.38 USD to near parity. The European Central Bank announced a massive quantitative easing (QE) program—€60 billion monthly bond purchases—to counter deflationary pressures and stimulate growth. Investors anticipating euro dilution sold euros short, driving its value down. Meanwhile, U.S. monetary policy diverged: the Federal Reserve ended QE and signaled future rate hikes, strengthening the dollar. The euro's depreciation benefited euro-area exporters: German auto manufacturers reported record overseas sales, leveraging cheaper prices. However, euro-area consumers faced higher import costs for electronics and fuel, squeezing household budgets. Tourism into Europe surged as Americans found European vacations more affordable. By 2017, the euro recovered to about 1.20 USD as euro-area inflation approached target and the Fed delayed hikes. This episode illustrates how diverging monetary policies and market expectations shift currency values, creating winners—exporters and inbound tourists—and losers—domestic consumers and import-reliant firms.

1. How did the ECB's QE announcement and Fed's tapering signal affect the EUR/USD rate?

2. Who benefited most from the euro's depreciation, and who were the primary losers?

Multiple Choice

1. If Country A's central bank raises interest rates, its currency will likely:

    a) Remain unchanged even if inflation is high

    b) Appreciate as foreign investors seek higher returns

    c) Depreciate significantly if trade balance improves

    d) Depreciate due to much cheaper borrowing costs

2. A floating exchange rate means:

    a) Only central banks trade that currency

    b) The government sets a fixed band around a target

    c) Market forces determine the rate

    d) The currency is pegged to gold

3. When a currency depreciates, domestic inflation may rise because:

    a) Capital inflows are increasing rapidly

    b) Government debt service costs fall sharply

    c) Exports become much more expensive

    d) Imports cost more in local currency

Matching

Write the letter of the correct definition on the line next to each term.

Term	Definition
1. ___ Appreciation	A) When a government pegs its currency's value
2. ___ Depreciation	B) A market where currencies are traded
3. ___ Forex	C) Decrease in a currency's value relative to another
4. ___ Fixed Exchange Rate	D) Rate set by supply and demand without central control
5. ___ Floating Exchange Rate	E) Increase in a currency's value relative to another

Fill-in-the-Blank

1. Buying or selling currencies in hopes of profiting from rate changes is called _____.

2. _____ easing injects money into the economy by buying government bonds.

3. A trade _____ helps measure net exports and services in a country's current account.

Short Answer

Answer each question in 2-4 complete sentences.

1. Explain why a stronger domestic currency can hurt exporters.

_____

_____

_____

2. Describe one reason a central bank might intervene in forex markets.

_____

_____

_____

3. How do speculators influence short-term currency fluctuations?

_____

_____

_____