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Chapter 1

Introduction

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Definitions

- **(Bilateral) (spot) exchange rate**, S, is (domestic currency) price of unit of foreign currency (FX)
- This the Direct Quotation method
- so rise (fall) in S is fall (rise) in value of domestic currency (depreciation)
- Another way of quoting a currency is the Indirect Quotation method: amount of foreign currency per one unit of domestic currency

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Definitions

Assuming the US$ as the numeraire currency, knowing N bilateral exchange rates of the dollar we can generate N(N-1)/2 cross rates.
Cross exchange rate = ratio of two bilateral exchange rates against the $, since deviations create profit opportunities for traders
Assume (unless stated otherwise) free capital movements i.e. currency fully convertible.

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Definitions

EXCHANGE CROSS RATES

Sep 17		C$	DKr	Euro	Y	NKr	SKr	SFr	£	$
Canada	C$	1	5.527	0.742	83.12	5.905	6.835	0.979	0.619	0.968
Denmark	DKr	1.809	10	1.343	150.4	10.68	12.37	1.771	1.120	1.752
Euro	Euro	1.347	7.447	1	112.0	7.956	9.210	1.319	0.834	1.305
Japan	Y	1.203	6.649	0.893	100	7.104	8.223	1.177	0.745	1.165
Norway	NKr	1.694	9.360	1.257	140.8	10	11.58	1.657	1.049	1.640
Sweden	SKr	1.463	8.086	1.086	121.6	8.639	10	1.432	0.906	1.416
Switzerland	SFr	1.022	5.648	0.758	84.95	6.034	6.985	1	0.633	0.989
UK	£	1.615	8.925	1.198	134.2	9.535	11.04	1.580	1	1.563
USA	$	1.033	5.708	0.767	85.86	6.099	7.060	1.011	0.640	1

Danish Kroner, Norwegian Kroner And Swedish Kroner per 10; Yen per 100Source: FT derived from WM Reuters.

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Definitions

- Effective exchange rate (EER)
- Real exchange rate (RER)
- Real effective exchange rate (REER)

- Spot vs Forward Rate

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Demand for currency/FX

- UK residents demand $ in exchange for £ in order to import from or invest in USA
- US residents demand £ in exchange for $ in order to import from or invest in UK
- Speculators buy or sell £ (sell or buy $) – whichever looks more profitable at the time
- Total excess demand/supply eliminated instantaneously by exchange rate movement.

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1.2 The market for foreign currency

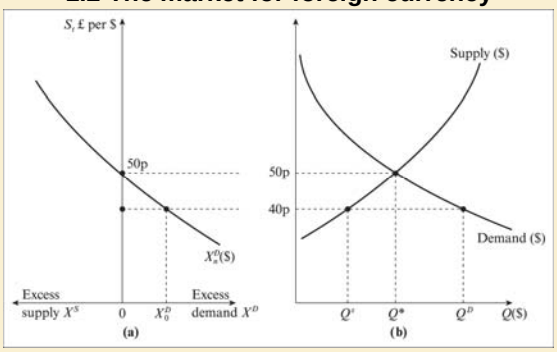

Figure 1.1 Supply and demand in the market for foreign currency

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Floating versus fixed exchange rate

- Pure float: exchange rate at any moment determined by net demand for currency
- Fixed exchange rate: monetary authority intervenes by (a) buying up excess supply of $ with £ (when £ strong, $ weak) or (b) satisfying excess demand for $ by selling $ for £ (when £ weak, $ strong), so as to prevent excess demand /supply affecting rate
- (a) adds $ to FX reserves, adds to £ in circulation
- (b) takes $ out of FX reserves, reduces £ in circulation.

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1.2.1 Floating rates

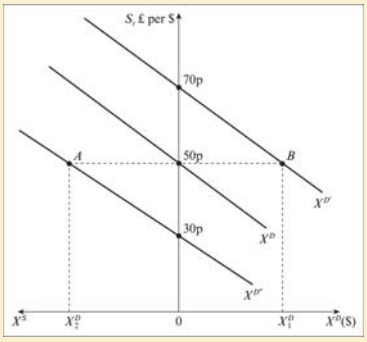

Figure 1.2 Shifts in the excess demand for foreign currency

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1.3 Balance of payments

1. **Current account**: export receipts as credits, import payments as debits, net = ***current account balance*** (goods, services including financial services, interest and dividends, rent, tourism)
2. **Capital account**: net capital inflows = net purchases of £ by foreigners in order to acquire claims on UK residents *less* net sales of £ by UK residents in order to acquire claims on foreigners (**long-term** including securities – equities, bonds etc., real estate etc. **+ short-term** including bank deposits, short-term securities)

   Total net underlying demand for £ = 1 + 2 (**basic balance**) is equated to zero by exchange rate movement, unless Government intervenes to fix exchange rate, in which case:
3. **Reserve change** = – (1 + 2) to prevent basic balance causing exchange rate to move.

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	£000m		
Goods and services		**−54.4**	
Goods	−83.6		
Services	29.2		
Current income		**18.5**	
Employees' income	−0.8		
Investment income	19.3		
Transfers		**−11.9**	
Government transfers	−9.6		
Non-governmental transfers	−2.3		
Current account			**−47.8**
Capital account			**0.8**
Financial account			**32.7**
Direct investment	7.4		
Portfolio investment	−43.5		
Financial derivatives	7.4		
Other investment	61.0		
Reserve change	0.4		
Errors and omissions			**14.1**

Table 1.3 UK balance of payments 2006

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Exchange rates since 1945

- Bretton Woods 1944–68 US $ fixed at 1 oz gold = $35, all other currencies fixed to $ with ± 1% fluctuation bands, devaluations to correct persistent deficits
- Breakdown 1968–73 as US printed excess $ causing worldwide inflation and flight into gold, other currencies (DM, Yen)
- Floating Era 1973 onward managed floats for most convertible currencies at first, but later experiments with limited fixed systems e.g. ERM in Europe, currency boards in Hong Kong, Argentina
- EMU 1998 onward response to failure of fixed exchange rates
- Increasing importance of Asian exchange rates 2000 onward especially RMB, Won, Rupee (varying degrees of flexibility/convertibility, increasingly linked to $/€/Yen currency basket).

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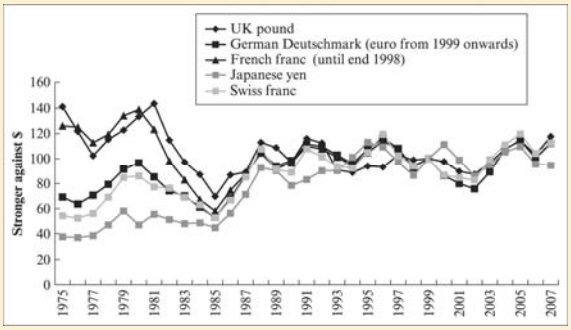

Figure 1.3 Exchange rates against the US dollar, 1975–2007 (1999 = 100)

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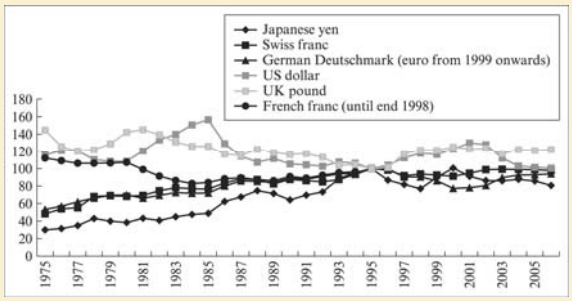

Figure 1.4 Effective exchange rates (trade-weighted), 1975–2006

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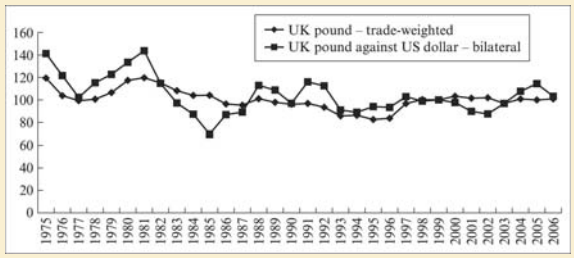

Figure 1.5 The pound (trade-weighted and bilateral), 1975–2006

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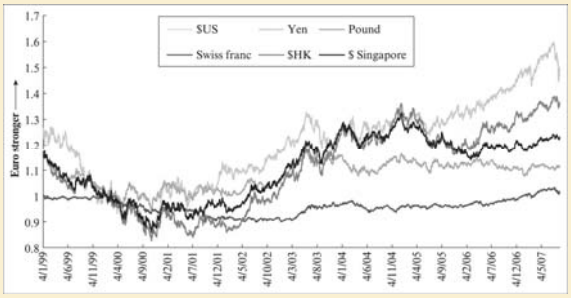

Figure 1.6 The euro since 1999: currencies per €

Note: each exchange rate is the daily closing mid-price of €1.00. For US$, the data are unscaled. The other five exchange rates are scaled so that 25/01/00 = 1.0, to match the $US, which actually stood at €1.00 = $1.0008 on that day

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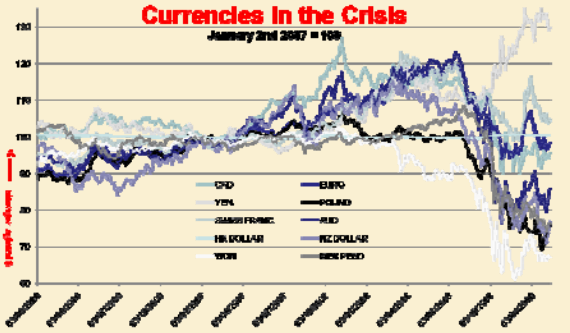

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