11.4: Factors Influencing Exchange Rates

Figure 11.4.1: Exchange rates are influenced by trade balances, investment, spectulation and the actions and policies of governments and central banks

In the above paragraph, we mention that supply and demand conditions are the primary factor setting exchange rates and leading to the changing values of currencies. What factors influence supply and demand and what impact do they have on exchange rates? There are too many forces that impact supply and demand to make an inclusive list, but here are a few examples.

Trade balances

When foreign firms and consumers purchase US goods and services, there is demand for US dollars (either because the US firms demand dollars or because they convert the foreign currency to dollars after the transaction). When US firms and consumers purchase foreign goods, there is increased supply of US dollars in the marketplace (either because US importers are selling dollars to buy foreign currency or foreign exporters are selling dollars to convert to their home currency after the transaction). Thus, when the US runs a trade deficit, we should expect weaker US dollar (and vice-versa). See the diagram below, which illustrates the supply curve shifting out from S to S1 to reflect increased selling of US dollars and the subsequent drop in the exchange rate.

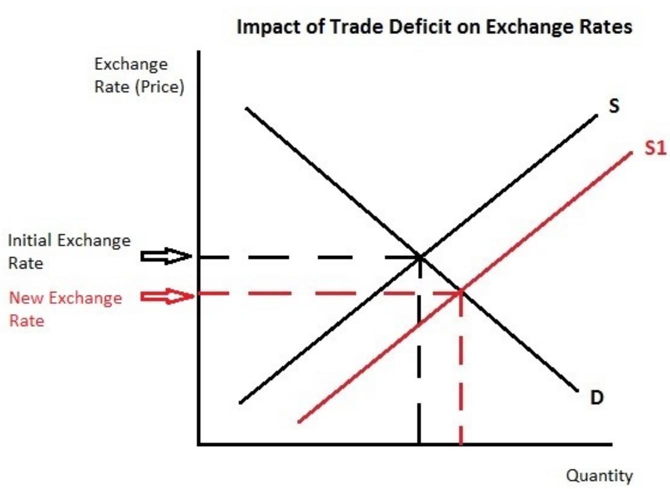

Figure 11.4.2: Showing how trade deficits can influence exchange rates

Investment

When foreign firms and individuals invest in the US (purchasing stocks/bonds, real estate, bonds, etc.), they need US dollars (creating demand for dollars). This is referred to as capital account activity. When US firms and individuals invest outside the US, the opposite situation develops (creating demand for foreign currencies). Thus, as investment flows into the US increase, the US dollar should get stronger (and vice-versa). As US interest rates and investment prospects increase, we would expect more net investment inflows into the US (and a stronger US dollar). As US interest rates and investment prospects decrease, we would expect more net outflows (and a weaker US dollar). See the diagram below, which illustrates the demand curve shifting up from D to D1 to reflect increased demand for US dollars due to higher relative interest rates in the US and the subsequent increase in the exchange rate.

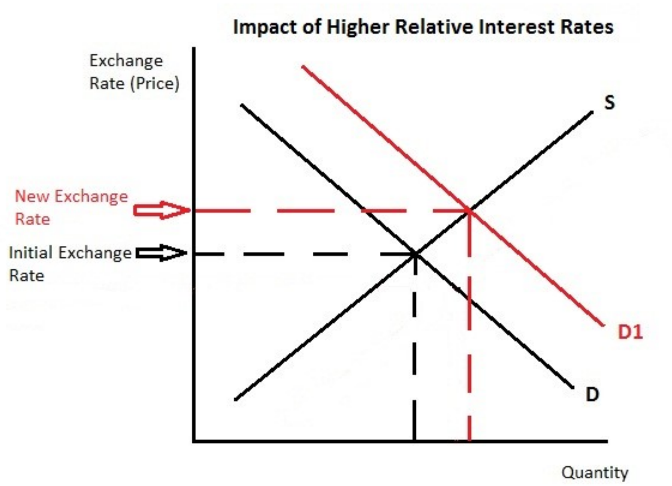

Figure 11.4.3: Showing how higher relative interest rates influence exchange rates

Sometimes supply and demand are driven by real economic forces (as in the two situations above) and sometimes by investor (currency speculator) psychology and expectations. For instance, if currency speculators anticipate that the US dollar is going to decline due to reduced demand or increased supply, then they will likely sell US dollars. This selling will result in increased supply and cause the value of the dollar to decline (assuming all other forces are held constant). Note that this looks like an easy way to make money. All a speculator has to do is to start buying US dollars and then the price will increase due to the increased demand that she created. However, several things make this much more difficult. First, she is one of many investors in the currency market and it is very unlikely she can buy/sell enough to move prices. Second, all the other factors impacting supply and demand are likely to dominate any influence her actions create. Third, even if she can raise the value of the US dollar by buying enough dollars, in order for her to profit she will need to sell them. If she made the price go up by buying, she will make the price go down by selling and offset her influence. Thus, any one speculator is not likely to influence prices. However as a group they will be one of the factors driving supply/demand.

Governments/Central Banks

The US Government (through the Treasury and Federal Reserve system) determine the monetary supply. Thus, they influence the amount of US dollars available in the markets (supply) and impact the value of the US dollar. Also, many foreign governments hold US dollars (as well as their own currencies) and can buy/sell these dollars (or change the supply of their currencies) to influence the market prices of exchange rates. Sometimes these actions are undertaken to influence exchange rates (the managed portion of the managed floating system) and sometimes they are done for other purposes (such as using monetary supply to influence inflation and economic activity).