16.1: Why It Matters- Exchange Rates and International Finance

Why learn about exchange rates and the way they influence international trade?

Figure 1.Trade Around the World. Is a trade deficit between the United States and the European Union good or bad for the U.S. economy? (Credit: modification of work by Milad Mosapoor/Wikimedia Commons)

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From 2002 to 2008, the U.S. dollar lost more than a quarter of its value in foreign currency markets. On January 1, 2002, one dollar was worth 1.11 euros. On April 24, 2008 it hit its lowest point with a dollar being worth 0.64 euros. During this period, the trade deficit between the United States and the European Union grew from a yearly total of approximately –85.7 billion dollars in 2002 to 95.8 billion dollars in 2008. Was this a good thing or a bad thing for the U.S. economy?

We live in a global world. U.S. consumers buy trillions of dollars worth of imported goods and services each year, not just from the European Union, but from all over the world. U.S. businesses sell trillions of dollars' worth of exports. U.S. citizens, businesses, and governments invest trillions of dollars abroad every year. Foreign investors, businesses, and governments invest trillions of dollars in the United States each year. Indeed, foreigners are a major buyer of U.S. federal debt.

Many people feel that a weaker dollar is bad for America, that it's an indication of a weak economy. But is it? This section will help answer that question.

The world has over 150 different currencies, from the Afghanistan afghani and the Albanian lek all the way through the alphabet to the Zambian kwacha and the Zimbabwean dollar. For international economic transactions, households or firms will wish to exchange one currency for another. Perhaps the need for exchanging currencies will come from a German firm that exports products to Russia, but then wishes to exchange the Russian rubles it has earned for euros, so that the firm can pay its workers and suppliers in Germany. Perhaps it will be a South African firm that wishes to purchase a mining operation in Angola, but to make the purchase it must convert South African rand to Angolan kwanza. Perhaps it will be an American tourist visiting China, who wishes to convert U.S. dollars to Chinese yuan to pay the hotel bill.

Exchange rates can sometimes change very swiftly. For example, in the United Kingdom the pound was worth about $1.50 just before the nation voted to leave the European Union (also known as the Brexit vote), but fell to $1.37 just after the vote and continued falling to reach 30-year lows a few months later. For firms engaged in international buying, selling, lending, and borrowing, these swings in exchange rates can have an enormous effect on profits.

This module discusses the international dimension of money, which involves conversions from one currency to another at an exchange rate. An exchange rate is nothing more than a price—that is, the price of one currency in terms of another currency—and so we can analyze it with the tools of supply and demand. First, we'll learn about foreign exchange markets: their size, their main participants, and the vocabulary for discussing movements of exchange rates. Next, we'll use demand and supply graphs to analyze some of the main factors that cause shifts in exchange rates. Finally, we'll bring the central bank and monetary policy back into the picture. Each country must decide whether to allow the market to determine its exchange rate, or have the central bank intervene. All the choices for exchange rate policy involve distinctive tradeoffs and risks.

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