

# Exchange Rates: Application of Supply and Demand to Currencies

ECO 120: Global Macroeconomics

# Goals

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## Unit Goals

- Interpret meaning of exchange rates
- Use exchange rates to convert prices and values from one currency to another
- Interpret changes in exchange rates in terms of currency's value against others
- Use a supply and demand model of currencies to predict changes in exchange rates.

## Learning objectives

- LO3: Use the supply and demand model for currencies to predict changes in exchange rates.

# Reading and Exercises

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- Textbook: Module 47
- Canvas Quiz due Wednesday 11:59 PM.  
Multiple-choice, 15 questions, unlimited attempts allowed, only best score counts
- Homework/In-class Exercise due Friday 11:59 PM. We will work together in class on Thursday.

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# Exchange Rates

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- **Nominal Exchange Rate:** how much of one currency can be traded for one unit of another currency.
- Example:
  - The Mexican Peso / U.S. Dollar exchange rate is 17.22 pesos / dollar (Feb 5, 2024).
  - One U.S. dollar can be exchanged for 17.22 pesos.
- There are two ways to express every exchange rate.
- Same example:
  - The Mexican Peso / U.S. Dollar exchange rate is 0.058 dollars / peso (Feb 5, 2024).
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## Changes in the Exchange Rate

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- **Appreciation:** A currency appreciates against a second currency when one unit of the first currency can purchase *more* of the second currency.
- **Depreciation:** A domestic currency depreciates against a second currency when one unit of the first currency can purchase *less* of the second currency.
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## Converting From One Currency to Another

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## MXN to USD

Suppose the price of a bike in Mexico is 8,440 MXN.

How much does this cost in USD?

$$8,440 \text{ MXN} \times \left( \frac{1 \text{ USD}}{17.22 \text{ MXN}} \right) \\ = 490.13 \text{ USD}$$

## USD to MXN

Suppose the price of a car in the U.S. 9,500 USD.

How much does this cost in MXN?

$$9,500 \text{ USD} \times \left( \frac{17.22 \text{ MXN}}{1 \text{ USD}} \right) \\ = 163,590 \text{ MXN}$$

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# Mexican Pesos per U.S. Dollar

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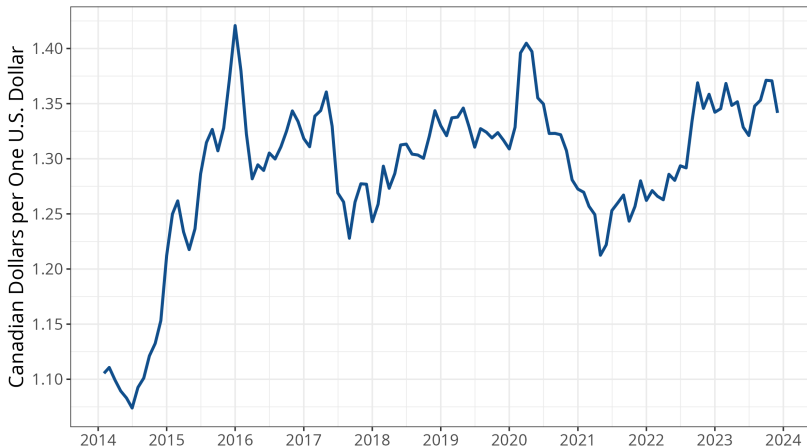
# Australia: U.S. Dollars per Australian Dollar

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# Canada: Canadian Dollars per U.S. Dollar

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# China: Chinese Yuan per U.S. Dollar

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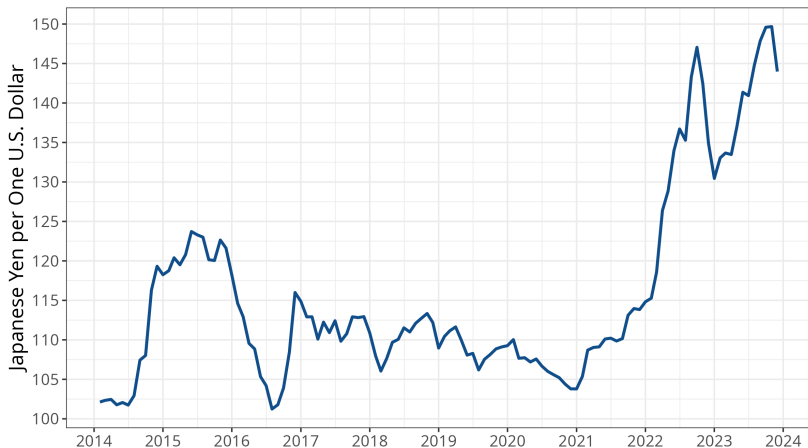
# Europe: U.S. Dollar per Euro

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# Japan: Japanese Yen per U.S. Dollars

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# South Korea: Korean Won per U.S. Dollars

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# Trade-Weighted Index

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- Weighted average of many currencies, based on level of trade.
- Includes: Euro Area, Canada, Japan, United Kingdom, Switzerland, Australia, and Sweden.



# Demand for Currency

- Price of currency of interest (say U.S. Dollars):
  - Exchange rate expressed as foreign currency per one unit of currency of interest.
  - Example: price of dollars = Euros per U.S. dollar.
  - An increase in this exchange rate means an appreciation of the dollar.
- Demand for currency is a *derived demand*. It depends on...
  - *foreign demand* for the country's goods.
  - *foreign demand* for the country's assets.
  - Financial assets could include stocks and bonds for companies in a country, government bonds from a country
  - Assets may include foreign direct investment, when owners from a foreign country own significant portions of a company or a company's facilities located in a country.

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# Shifts in Demand

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- Determinants of demand for currency:
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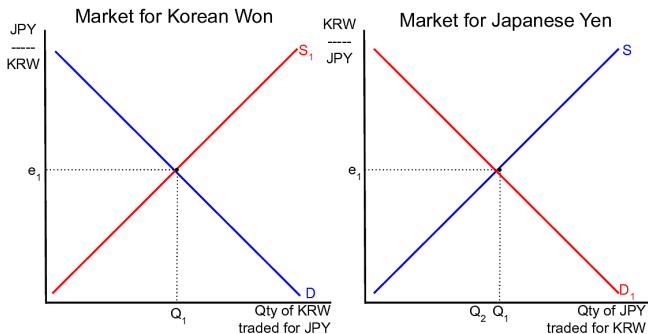
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Japan and Korea are major trading partners. Suppose there is a decrease in incomes in Korea, leading to a decrease in demand for imported goods from Japan to Korea

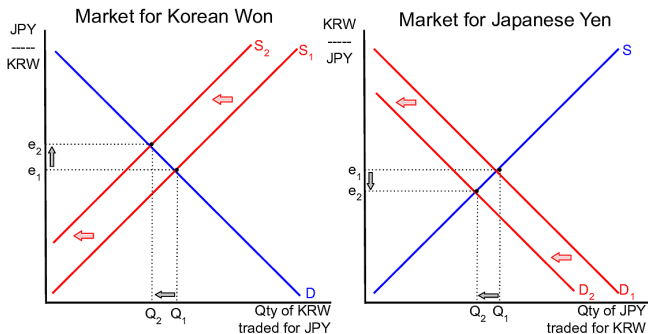


Two related markets. Market for Korean Won (Price= $\text{JPY}/\text{KRW}$ ) and Market for Japanese Yen (Price= $\text{KRW}/\text{JPY}$ )

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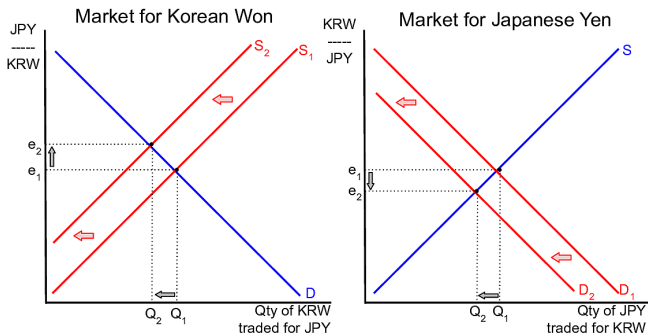
Decrease in Koreans' demand for Japanese Yen  
→ Decrease in Supply of Korean Won.



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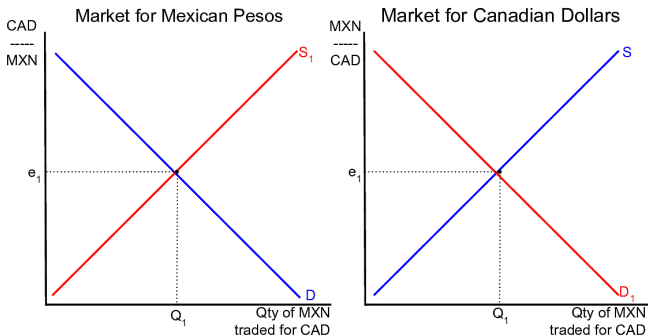


Korean Won appreciates against the Japanese Yen  
Equivalently, Japanese Yen depreciates against Korean Won

# Example: Reduction in Trade Restrictions

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Suppose a trade agreement between Mexico and Canada results in a significant reduction in legal restrictions in Mexico, allowing more imports from Canada.

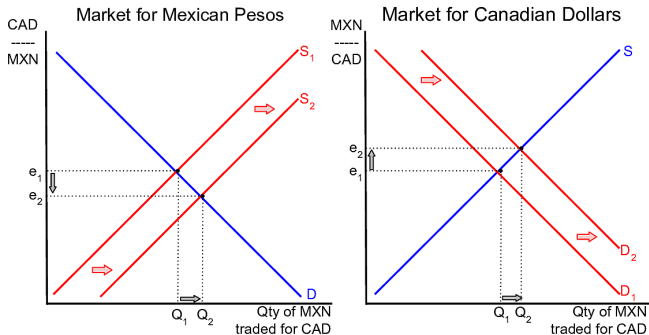


Two related markets. Market for Mexican Pesos (Price=CAD/MXN)  
and Market for Canadian Dollars (Price=MXN/CAD)

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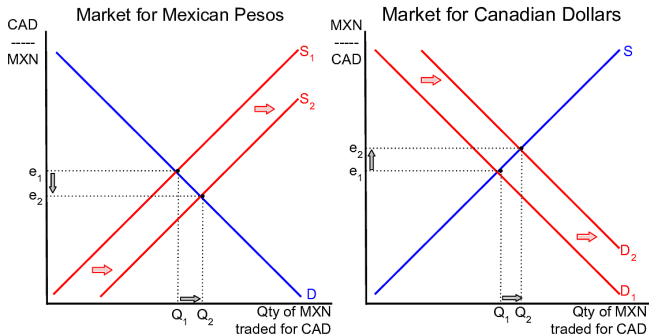
Increase in Mexican consumers' demand for Canadian Dollars

→ Increase in Supply of Mexican Pesos.

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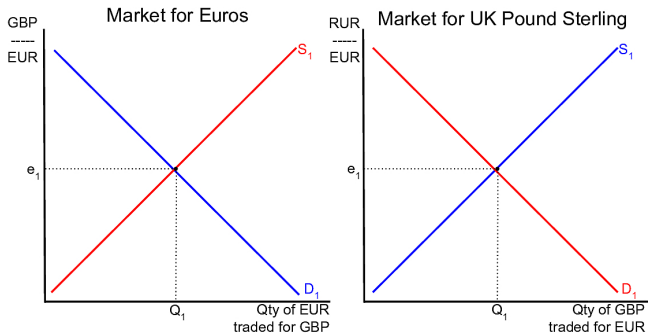
Mexican Peso depreciates against the Canadian Dollar

→ Canadian Dollar appreciates against the Mexican Peso

## Example: Increase in U.K. Interest Rate

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Suppose interest rates in the United Kingdom increase, but stay the same in the Euro area.

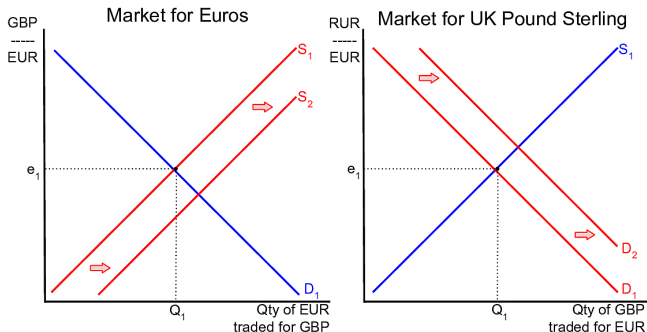


Two related markets. Market for Euro (Price=GBP/EUR)  
and Market for U.K. Pound Sterling (Price=EUR/GBP)

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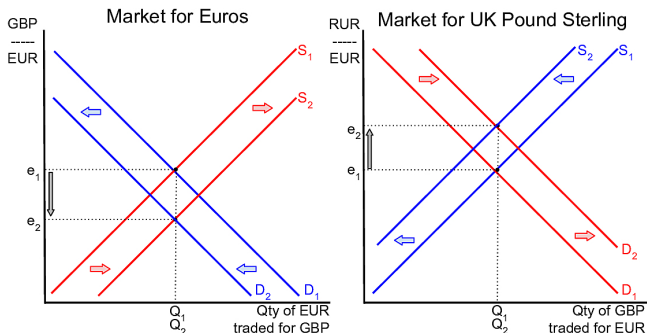
Increase in Euro-area investors' demand for U.K. Pounds

→ Increase in Supply of Euros

## Example: Increase in U.K. Interest Rate

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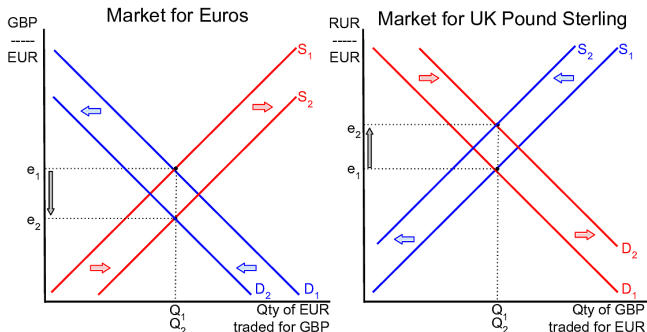
Decrease in British investor's demand for Euros

→ Decrease in Supply of U.K. Pounds.

## Example: Increase in U.K. Interest Rate

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Euro depreciates against the U.K. Pound Sterling

→ U.K. Pound Sterling appreciates against Euro



# Spotlight: Oleg Itskhoki & Dmitry Mukhin

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**Sanctions and the Exchange Rate**, *NBER Working Paper*, April 2022.

## Impact of Sanctions Depends

- Sanctions that prevent financial investment in the country cause the country's currency to depreciate
- Sanctions that limit availability of imports into a country cause the country's currency to appreciate
- Explains both upward and downward movements in USD / RUB exchange rate following Russia's February 2022 invasion of Ukraine



**Dr. Oleg Itskhoki** (left)  
Professor of Economics  
University of California-Los Angeles



**Dr. Dmitry Mukhin** (right)  
Asst Professor of Economics  
London School of Economics

## Russia: Russia Ruble per U.S. Dollars

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## Scholar Spotlight: Markéta Arltová

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### The Impact of Economic Sanctions on Russian Economy and RUB/USD Exchange Rate, *Journal of International Studies*, 2018.

(with Ladislav Tyll and Karel Pernica)

#### Economic Sanctions, Exchange Rates, and Food Prices

- International price of oil positively affects USD/RUB exchange rate
- International sanctions following Crimea annexation decreased USD/RUB 2014-2016
- Depreciation of RUB increased imported food prices
- Russia counteracted exchange rate impact with import restrictions, including on food



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## Reading and Exercises

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- Canvas Quiz due Wednesday 11:59 PM.  
Multiple-choice, 15 questions, unlimited attempts allowed, only best score counts
- Homework/In-class Exercise due Friday 11:59 PM. We will work together in class on Thursday.

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