# Chapter 25 – The Exchange Rate and the Balance of Payments

**The Foreign Exchange Market**

*Foreign Currency*

To buy goods and services produced in another country we need money of that country.

Foreign bank notes, coins, bank deposits are called foreign currency.

*Forex Market*

The foreign exchange market is the market in which the currency of one country is exchanged for the currency of another.

*Conversion of one currency and the ups & downs of the Currency valuation*

The price at which one currency exchanges for another is called a foreign exchange rate.

A fall in the value of one currency in terms of another currency is called currency depreciation

A rise in the value of one currency in terms of another currency is called currency appreciation

*The Exchange Rate*

The exchange rate is the number of foreign currency units one can buy with one unit of domestic currency.

If BoC control the rate of exchange and decreases the value of CAD, it is called devaluation

If BoC control the exchange rate and increases the value of CAD, we say revaluation of CAD

An Exchange rate is a price – the price of one currency in terms of another

The rate is determined in foreign exchange market

*Demand in the Forex Market*

Demand for one money is the supply of another

Currency the traders plan to buy in the foreign exchange market depends on:

1. The exchange rate (-)
2. Interest rates in US and other countries (-)
3. World demand for Canadian exports (+)
4. The expected future exchange rate (+)

The demand for dollars is a derived demand

*The Law of Demand for Forex*

Other things remaining the same, the higher the exchange rate, the smaller is the quantity of Canadian dollars demanded in the foreign exchange market.

The exchange rate influences the quantity of Canadian dollars demanded for two reasons:

Exports effect: The larger the value of Canadian exports, the greater is the quantity demanded in forex market. The lower the forex rate the greater is the value of Canadian exports, so the greater is the quantity of Canadian dollars demanded

Expected profit effect: The larger the expected profit from holding CAD, the greater the quantity of Canadian dollars demanded today.

*Supply in the Forex Market*

The quantity of CAD supplied in the forex market is the amount that traders plan to sell during a given time period at a given exchange rate which interestingly depends on

1. The exchange rate (+)
2. Interest Rates in Canada and other countries (-)
3. Canadian demand for imports (+)
4. The expected future exchange rate (-)

*The Law of Supply of Forex*

Other things remaining the same, the higher the exchange rate, the greater is the quantity of Canadian dollars supplied in the foreign exchange market.

The exchange rate influences the quantity of Canadian dollars supplied for two reasons:

Imports Effect: The larger the value of Canadian imports, the larger is the quantity of Canadian dollars supplied on the foreign exchange market.

The higher the exchange rate, the greater is the value of Canadian imports, so the greater is the quantity of Canadian dollars supplied

Expected profit effect:

**Exchange Rate Fluctuation**

*Changes in Demand for CAD*

A change in the demand for quantity of CAD the people plan to buy, other than the exchange rate, brings a change in the demand for CAD

These other influences are:

World demand for Canadian exports (+): If the demand for C-exports increases, the demand for CAD increases.

Canadian interest rate relative to the foreign interest rate (+): Canadian interest rate minus the foreign interest rate is called Canadian interest rate differential

The expected future exchange rate (+): if expected future rate rises then demand curve shift right else left.

*Changes in the Exchange Rate*

If demand for Canadian dollars increases and supply does not change, the exchange rate rises.

If demand for Canadian dollars decreases and supply does not change, the exchange rate falls.

If supply of Canadian dollars increases and demand does not change, the exchange rate falls.

If supply of Canadian dollars decreases and demand does not change, the exchange rate rises.