Exchange Rates

What is an exchange rate?

An exchange rate is the **price of one currency expressed in terms of another currency.**

The exchange rate determines how much of one currency has to be given up in order to buy a specific amount of another currency.

For example, look at the exchange rates in the following table:

£1 buys	May	September
US Dollars ($)	$1.60	$1.45
Euros (€)	€1.15	€1.05

In the table above, you can see that in May, £1 would buy $1.60, if you wanted to convert some pounds into US dollars. Alternatively, £1 would buy €1.15 euro.

Exchange rates change constantly as currencies are bought and sold (traded) on the global currency markets. Let any commodity, a currency has a value or price expressed in terms of what it could buy – that is the exchange rate.

Look at the table and see what happened to the exchange rate for the pound between May and September.

The value of £1 fell against both the US dollar and the Euro. For example, by September, £1 would only buy you $1.45, a fall of $0.15 from May.

That means that the pound **weakened** against the dollar (and the euro).

Putting it another way, the value of the US dollar **strengthened** against the pound. If you were holding dollars, you would need less of them to convert into £1.

Causes of movements in exchange rates

An exchange rate is a price of a currency. The price is determined by the **forces of demand and supply** in the currency markets.

Just like the commodity markets for wheat, oil and coffee, the price of a currency will reflect the amount of the currency that consumers and businesses want to buy (demand) and sell (supply).

Currencies are traded on in international currency markets 24 hours a day. Many billions of pounds and other currencies are traded every hour, to service the needs of governments, businesses and millions of individuals.

For example, here are some reasons why there is demand for a currency:

- Businesses need to pay for invoices from overseas suppliers (e.g. a US supplier sending goods to the UK and pricing the invoice in dollars)
- Businesses needing to convert payments they have received from customers in one currency into another (e.g. a customer in Italy pays a UK business in Euros – which it wants to convert into pounds before putting it in the bank)
- Consumers and business people buying currency before taking a trip or holiday overseas.
- Businesses sending back profits (cash) from their overseas operations to the base currency

Currency markets are also affected by speculative demand and supply. Currency traders bet on which way they think exchange rates will move. If they think that there will be excess demand for a currency and that it will strengthen, then they may buy that currency and then look to sell the currency when the exchange rate has risen (making a profit)

A currency is also affected by interest rates. For example if interest rates in the UK rise, then holders of other currencies may swap them into pounds in order to gain access to a higher interest rate.

Implications for UK businesses if the pound strengthens

A good way to look at what happens if a currency strengthens (an increase in the exchange rate) is to work through an example.

£1 buys	January	June
US Dollars ($)	$1.40	$1.60

Brandon Ltd imports electronic goods from the US for sale via a UK website. These goods are invoiced in US$ - and that is the currency that Brandon must use to settle the invoices. Each month they pay their American suppliers approximately $100,000 for goods imported into the UK.

What is the effect of the strengthening pound in the table above on Brandon Ltd?

Let's convert the monthly US dollar payment to suppliers ($100,000) into pounds to see how much Brandon has to pay:

£1 buys	January	June
US Dollars ($)	$1.40	$1.60
$100,000 converted into £	£71,428	£62,500

In June, Brandon Ltd needs to spend £62,500 to pay for their $100,000 of imported goods from the US. This is £8,928 **less** than in January. That means, for Brandon ltd, the cost of imports has gone down. A strengthened pound has led to cheaper imported goods – that's good news for Brandon Ltd (they should be able to make a better profit margin on those imported electrical goods).

If a strengthened exchange rate is good news for an importer like Brandon, what about a business that sells from the UK to the USA – an **exporter**?

Take the example of Huntington Plastics Ltd. Huntington exports moulded plastic components to customers in the US, invoicing in US dollars. What would the effect of a strengthened exchange rate be for Huntington?

£1 buys	**January**	**June**
US Dollars ($)	$1.40	$1.60
$100,000 converted into £	£71,428	£62,500

If Huntington received $100,000 in sales in January, they could be converted into £71,428.

But in June, the same $100,000 of sales would only be worth £62,500. That's bad news for Huntington. A strengthened pound has resulted in lower sales.

If Huntington were to invoice their exports in pounds rather than dollars, then they might not be directly affected by the changed exchange rate – since there are no foreign currency receipts to convert back into pounds. However, the business might still suffer, since the price of Huntington products would be more expensive for US customers, who might then buy less (perhaps buying from a cheaper domestic supplier).

Let's summarise:

A stronger pound leads to:

Imports being cheaper

Exports dearer (more expensive)

Here is an acronym that can help you remember that: SPICED

S - Stronger
P - Pounds
I - Imports
C - Cheaper
E - Exports
D - Dearer

What happens if the pound weakens (i.e. falls in value against other exchange rates)?

The answer is – the opposite of a stronger pound.

Imports become more expensive for UK importers

Exports become cheaper in overseas markets.

Simple!