



Let's say you're planning to go to Hawaii next December. You need to save two thousand dollars for the trip because the airfare is one thousand dollars, the hotel is five hundred dollars and you figure it's going to cost five hundred dollars for meals and entertainment.

Your friend tells you that you should go to Cancun instead because it's a lot cheaper and really nice. You go online and find that the airfare is five hundred dollars and the hotel will cost about two hundred and fifty dollars. How much do you need for meals and entertainment?

It's pretty easy to figure out the cost of meals and entertainment for Hawaii since the prices are all in American dollars. You know that everything is going to be more expensive than where you live, but prices won't change that much between now and your trip.

Cancun is a different story. Since it's in Mexico, the prices are all in pesos, which is the national currency. How many pesos can you buy with your dollars? Today you get so many pesos per dollar, but tomorrow you might get fewer or more. This can change a lot over a few months so that your food and entertainment bill might be much higher or much lower than you expect.

Planning your expenses is more difficult when you go to foreign countries. Imagine how difficult it can be for businesses! Let's see how prices are set for currencies, and how this can affect international trade.

DEFINITION

Exchange Rate

Amount of currency it takes to buy one unit of currency in another country.



The exchange rate is the amount of currency it takes to buy one unit of currency in another country. If you went to Mexico, the exchange rate would be how many pesos you can buy with, or vice versa. Exchange rates change daily, but prices for goods usually don't. How can you figure out what things cost?

Let's say a hamburger costs fifty pesos in your Cancun hotel. How much is that in dollars? Say the exchange rate today is ten pesos to the dollar. You divide the cost of the hamburger, fifty pesos, by the exchange rate, ten pesos to the dollar and come up with a price of five dollars for the hamburger.

Say tomorrow the exchange rate is *ten point five* pesos to the dollar; one dollar buys more pesos. Dividing the price of the hamburger by the exchange rate, we come up with a price of four dollars and seventy-six cents, almost twenty five cents cheaper. What about if the exchange rate was *nine point five* pesos instead? The same hamburger that costs fifty pesos would now be five dollars and twenty-six cents, almost a quarter more expensive than it is today.

If you go to Cancun, you'd better keep a close eye on the exchange rate because it can have big effect on how much you spend on your vacation.

How are Rates Set?

Supply and Demand Sets Prices

As demand for one currency goes up, it costs more to buy this currency, and as demand goes down, it costs less.



So, who sets the exchange rate? Most of the exchange rates for the world's currencies are set by buyers and sellers on the foreign exchange market, a network of about two thousand banks and financial institutions located in various financial centers around the world like New York, London, and Tokyo. Twenty-four hours a day, five days a week, these institutions let buyers and sellers exchange different currencies. All of the institutions that make up the foreign exchange market maintain close contact with each other so that financial transactions and market information are immediate.


How are the exchange rates set? Like other goods, the prices of different currencies are set by supply and demand. As demand for one currency goes up, it costs more to buy this currency, and as demand goes down, it costs less. Many economists believe that currency markets are the closest thing we have to perfect markets because, thanks to computerized transactions, money is easily exchanged between buyers and sellers.

Who are these buyers and sellers? Large businesses and banks as well as governments are some of the biggest institutions, but there are also smaller investors and businesses involved. All of them must buy and sell currencies through the foreign exchange market.

Stronger and Weaker Currencies

Currency goes up in price
Getting stronger

Currency down up in price
Getting weaker



	Cost		Revenue
1,000 pesos – 1 windshield			\$120 per windshield
Exchange rate = 10 pesos – \$20 profit per windshield			
Exchange rate = 10.5 pesos - \$5 extra profit			
Exchange rate = 9.5 pesos – Profit goes down \$5			

As currencies go up in price with respect to other currencies, we say they are getting stronger, and when they go down in price, they are getting weaker. How does that affect people and businesses?

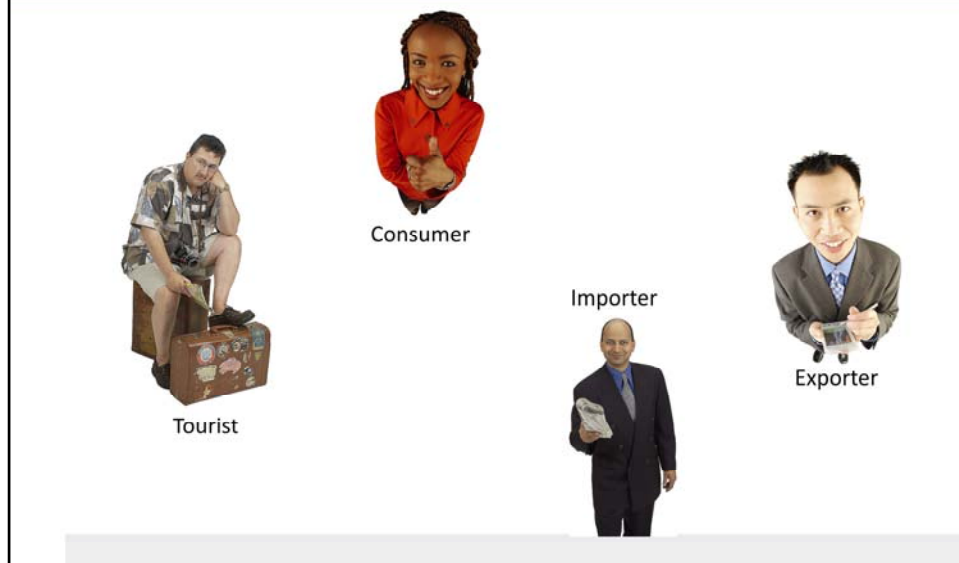
In our Cancun example, when the exchange rate went from ten to ten point five pesos to the dollar, the dollar got stronger, and the peso got weaker. You were able to buy more Mexican goods because your dollars were stronger. When the exchange rate went from ten to nine point five pesos to the dollar, the dollar got weaker, and each dollar could buy fewer goods in Mexico.

The same is true for businesses. Say you run a business supplying auto parts to Ford that are made in Mexico. It costs one thousand pesos to produce a windshield and the exchange rate is 10 pesos to the dollar. To convert this to dollars, we divide one thousand by ten and we get one hundred dollars. You have a contract with Ford that pays one hundred twenty dollars for each windshield, which means that you make twenty dollars profit on each windshield you make.

If the dollar gets stronger and the exchange rate goes to ten point five pesos, your costs remain at one thousand pesos, which is now equal to about ninety-five dollars. You make an additional profit of five dollars for each windshield.

If the dollar weakens and the exchange rate goes to nine point five pesos per dollar, it now costs you about one hundred and five dollars to produce the same windshield, and your profit goes down five dollars.

Strong/Weak Dollar Implications



So a stronger or weaker dollar has very different consequences depending on your situation; and the effect of a strong dollar is exactly opposite that of the weak dollar for each of these groups. Select each of the images to see how each person or group is affected by a stronger or weaker dollar.

Tourist

Strong Dollar - Tourists visiting countries with weaker currencies can buy more goods with the same amount of dollars. This can make your vacation much cheaper. Vacationers often go places with weak currencies since their money will go further.

Weak Dollar - Tourists visiting countries with stronger currencies need more dollars to buy the same amount of goods. This can make your vacation much more expensive. You might consider vacationing in the U.S. since your money will go further here than abroad.

Consumer

Strong Dollar - Consumers can buy more foreign goods with the same amount of dollars. When the dollar is strong, you might find that the price of foreign goods, like electronics or wine, go down if they come from a country with a weaker currency.

Weak Dollar - A consumer looking to buy something, you'll need more dollars to buy foreign goods. When the dollar is weak, the price of foreign goods goes up. You might buy the American made item instead.

Exporter

Strong Dollar - If you export goods to countries with weaker currencies, the price of your goods will go up in those countries and your profit will go down as people buy fewer of your goods. Since the dollar is stronger, you will have to raise the price of your products if you want to make the same profit.

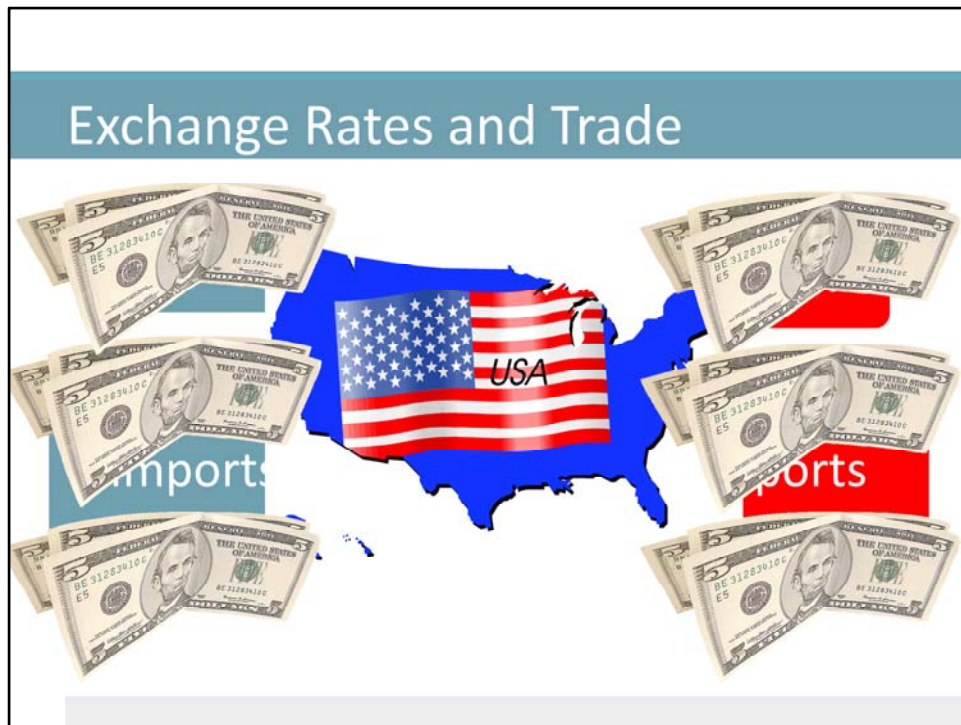
Weak Dollar - If you export goods to countries with stronger currencies, the price of your goods will go down in those countries and your profit will go up as people buy more of your goods. Since the dollar is weaker, you can actually lower the price of your products and still make the same profit.

Importer

Strong Dollar - If you run a business that uses imported parts, your profit goes up as your costs go down. As we saw with windshield company example, if you run a business that uses a lot of foreign components, as the dollar strengthens, products from that country become cheaper, and businesses make more profit.

Weak Dollar - A business that uses imported parts, your profit down up as your costs go up. As we saw with windshield company example, if you run a business that uses a lot of foreign components, as the currency weakens, products from that country become more expensive, and businesses make less profit.





As you can see, the strength of the dollar has a large impact on businesses and consumers. Over the long term, this can affect the balance of trade between countries.

As the dollar becomes weaker, products from the U.S. become cheaper in other countries, and exports increase. Also, the price of imports goes up, and consumers buy fewer goods from abroad. When exports go up, and imports go down, trade deficits decrease or may even become surpluses.

The reverse is also true. As the dollar becomes stronger, products from the U.S. become more expensive in other countries, and exports decrease. Also, the price of imports goes down, and consumers buy more goods from abroad. As exports go down and imports go up, trade deficits increase.

Although it might seem to be in the interest of the U.S. to always have a weaker currency, a strong currency can be positive for the country. For example, it attracts investment in U.S. companies from around the world.

What makes a currency go up or down



There are many reasons that a currency might become stronger or weaker. National governments may spend large amounts of money to try and influence exchange rates in order to make their products cheaper. For example, some governments, like China's, spend extremely large amounts of money to keep their currency at about the same exchange rate with the dollar in order to promote their exports. Governments with low levels of debt often have strong currencies while those with high deficits have weaker ones.

As a consumer, you are primarily affected by exchange rates when you travel abroad, or when you go to the store. You might not realize how important the strength of the dollar is for businesses and job growth. It's also an important topic that often comes up between international trading partners.

The Effect of Exchange Rates

Question

Determine the most likely cause or outcome of the following scenarios.

PROPERTIES

On passing, 'Finish' button:

On failing, 'Finish' button:

Allow user to leave quiz:

User may view slides after quiz:

User may attempt quiz:

Goes to Next Slide

Goes to Next Slide

After user has completed quiz

At any time

Unlimited times

