

## Exchange rates and Interest rates

Specification requirement—The impact on business of movements in interest rates and exchange rates.

The relationship between interest rates and exchange rates and their impact on imports and exports and UK businesses.

### What is an exchange rate?

An exchange rate is the value of one currency expressed in terms of another currency. So for example the value of the £ can be given as \$1.60, or as € 1.25. This means that £1 can buy \$1.60, or £1 can buy € 1.25.

Exchange rates vary on a minute by minute basis, and the main determinant of these short-term changes in exchange rates is the action of currency speculators. These speculators, working in the main for banks or financial institutions, essentially gamble on small movements in different exchange rates. If speculators take the view that a currency is likely to fall in value, they will sell that currency, weakening demand for the currency and so reducing its value.

In the longer term the main determinants of the value of one currency in terms of another are the relative strength of the economies concerned, and the different levels of inflation suffered by each country. Over most of the 20th century the value of the £ has fallen against the value of competitor countries currencies, this relative fall was most especially noticeable during the late 60's and throughout the 70's, and has been repeated over the last year or so (2008-9). It is also worth noting that the current free floating £, is almost the exception. For most of the

post second world war period the value of the £ was fixed against other currencies (under the Bretton Woods system), or actively managed, ( when the £ shadowed the DM, and during the period when the £ was part of the ERM). It is only since 1993 that the £ has been allowed to float relatively freely on the foreign exchange markets, where the value of the £ will be determined by supply and demand factors.

### Effects of exchange rate changes on UK business.

#### Fall in the value of the £.

Importers.

In terms of their own currency importers will find imports more expensive to buy. They can react to this in one of two ways. Firstly reduce their margins and so not pass the increased cost on to the consumer, or secondly pass increased costs onto the consumer in the form of higher prices. The decision will come down to; how large are the margins and what is the price elasticity of demand for the product.

Exporters.

Exports will be cheaper in terms of the purchasing businesses own currency (less \$'s to pay), so firms should find winning export markets easier. They can react by increasing the price in £'s, so maximising their profits, or keeping their prices the same, and trying to win new markets.

#### Rise in the value of the £.

Importers.

In terms of their own currency they will find imports less expensive to buy. They can react to this in one of two ways. Firstly increase

their margins and so not pass the reduced cost on to the consumer, or secondly pass reduced costs onto the consumer (this can be done by improving the product e.g. more ram in a computer or air conditioning in cars, or by lowering the retail price). The decision will come down to balancing short-term profit maximisation against winning consumer loyalty.

Exporters.

Exports will be more expensive in terms of the purchasing businesses own currency (more \$'s to pay). Firms will find winning and keeping export markets a great deal harder. They can react by reducing the price in £'s, so reducing their profits, or keeping their prices the same, and trying to retain markets by strength of brand or quality of good.

### Worked example.

A British importer of mountain bikes from the USA places an order for 400 Muddy Badger bikes at \$200 each with the manufacturer. At the time of order the exchange rate is £1 to \$1.60, but when the invoice arrives for payment the exchange rate is £1 to \$1.47. How much extra in £'s has the change in the exchange rate cost the importer?

400 times \$200 = \$80,000

divide by exchange rate to find the cost in £'s

\$80,000 divided by 1.60 = £50,000

at time of invoice exchange rate is £1 to \$1.47, so

\$80,000 divided by 1.47 = £54,421

So the change in exchange rate has increased the importers costs by £4,421.

### Current Situation.

At the time of writing (Feb 2013), the £ is generally considered to be slightly overvalued in the currency markets and as a result the value of the £ is expected to fall over the next year, making foreign holidays more expensive.

Many exporting and importing businesses suffer losses to profits, or lost markets because of fluctuations in exchange rates. British businesses benefited greatly after the £ left the ERM (1992), as the value of the £ rapidly fell, this made exports more competitive, and imports less competitive. Over the last 6 years the £ had initially been relatively strong, reversing the above situation, but more recently, as indicated above, the £ has fallen in value.

Many business leaders and economists argue that the long term solution to problems caused by currency fluctuations is to join the €, the single currency. For more on this see the chapter on The Single Currency.

### Monetary Policy

Monetary policy is based on controlling the money supply to the UK economy and the costs of borrowing money i.e. interest rates.

Money supply in the economy can be measured in different ways. These different measures of what is money are known as M0, M1, M2, M3, M4. This on the face of it may seem strange to have different ways of counting money, but once we start to look at what makes up the money supply the need for different measures of what is money becomes ob-

vious.

M0 is the narrowest measure of money, it consists mainly of the notes and coins in circulation in the economy. The other measures become increasingly broad, including as part of the measurement of money supply, bank deposits, credit, treasury bills and so on. M4 is made up of notes and coins, plus building society deposits, bank deposits, and holdings of certificates of deposit. Bank deposits make up most of the money in the UK, banks create far more money than the government or the Bank of England.

### **How the government controls the money supply.**

The main tool of control of money supply is the use of interest rates. On coming to office in 1997 the last Labour government gave control of interest rate policy to the Monetary Policy Committee of the Bank of England. The MPC is given an inflation target by the government (currently CPI of 2%, plus or minus 1%), and by use of interest rates has the job of keeping inflation within the target band. This policy has been continued by the coalition government, but also with focus on reducing government borrowing and trying to get the economy out of recession.

Interest rates are an effective method of managing the money supply because they will directly affect the cost of money. The MPC sets a Base Rate, which is an indicator to the rest of the lending market, of how they should set their interest rates. At the time of writing (Feb 2013) the base rate stands at just 0.5%, and has been at this level for nearly 4 years. Back in 1992 the base rate went as high as 15%!

If interest rates increase, the cost of borrowing increases, this will limit demand in the economy. If interest rates fall then the cost of borrowing falls, so demand will increase.

Interest rates are then an effective tool for controlling demand in the economy, but there are problems. Firstly the MPC must base its decisions on information collected about what is happening in the economy. Sometimes this information later proves to be misunderstood or incorrect. For example in 1998, the MPC increased interest rates in an attempt to remove inflationary pressure which it believed was resulting from increased wage levels. Later interpretation of wage figures showed that in general wage levels were not increasing as fast as was thought - there was no need for the rise in interest rates. Also increases in interest rates push up the cost of existing borrowing, so increasing costs to firms. These increasing costs can reduce profitability, so reducing tax revenues for the government and decreasing competitiveness of businesses, meaning lost orders and markets.

From the individuals point of view increased interest rates can have disastrous consequences. High interest rates in the late 80's and early 90's massively pushed up the cost of mortgages, meaning that many individuals who had been encouraged into the housing market by easy credit and booming prices, lost their houses as they could no longer afford the repayments. The chancellor of the time justified this by saying 'if its not hurting, its not working'!

### **The Relationship between interest rates and exchange rates.**

Higher interest rates give a higher value to the pound, this is because high interest rates

encourage investment in the UK's financial system. To make this investment £s must be bought, so demand for £s increases, pushing up the value of the £ in terms of other currencies.

Of course if interest rates fall then the reverse is true. Lower interest rates lower the value of the pound, this is because low interest rates discourage investments in the UK financial system. So holders of £s may sell their £s and buy other currencies, this increases supply of £s onto the foreign exchange markets, lowering its value.

Both these examples do not always hold true. Currency movements will depend on relative interest rates between countries, and other factors can come into play such as confidence in the economy and levels of government borrowing.

## Notes