

## Handout 7-7-1

# Foreign Currencies and Foreign Exchange

Pesetas, liras, pounds, rubles, yen, and kroner. The world of foreign currencies often seems confusing. Not only are many of the names unfamiliar, but we also want to know what each is worth in terms of U.S. dollars.

Because all of these currencies are money, they all serve the same functions. Money is a medium of exchange, a store of value, and a measure of value. As a *medium of exchange*, money can be used to purchase (be exchanged for) goods and services. As a *store of value*, money can be saved to use in the future. As a *measure of value*, money allows us to express the price of things. We can say a car costs so many dollars, while an audio cassette costs many fewer dollars.

Now to a basic question: How do we know what a foreign exchange rate is; that is, how much is any currency worth in terms of other currencies? The simple answer is that a currency is worth whatever people are willing to pay for it. This means it is a case of supply and demand. If there is little quantity demanded for a country's currency or a great quantity available for foreigners to buy, the money will be worth less than if there is a high quantity demanded for it or only a small quantity supplied which foreigners might buy.

For example, when Americans increase their purchases of imports, more U.S. dollars are sent abroad or are exchanged for foreign currencies in order to pay for the imported goods. As the supply of dollars to foreigners thus increases, the dollar tends to be worth less in terms of other currencies. Under such conditions we say the dollar "depreciates." The same general analysis holds true for the currencies of other nations. If a currency increases its worth in terms of other currencies, we say it "appreciates."

Currency values are established and exchanges of currencies occur in foreign exchange markets. These markets exist at banks, at the offices of foreign exchange dealers, and other places where one country's currency or checks can be exchanged for those of another country. But the greatest amount of foreign exchange activity takes place by telephone, telex, or other rapid means of communication used by commercial banks, businesses, and others who deal in large amounts of foreign exchange.

Foreign exchange values can change every day — most days by small amounts; some days by enough to make a difference to the people or businesses that are "converting" (i.e., exchanging) one currency into another. In the longer run, changes of major magnitude can occur. In the early 1980s, the value of foreign currencies, in general, *fell* a great deal against the U.S. dollar. Looking at the situation the other way, the dollar *rose* a great deal against foreign currencies.

For example, in 1979 the worth of the Swiss franc in terms of the dollar averaged 60 U.S. cents, and the worth of the West German mark averaged 55 U.S. cents. In mid-February, 1985, the Swiss franc had fallen to about 36 U.S. cents and the West German mark to about 31 U.S. cents. In about five years or so, from the Swiss and German points of view, the franc had depreciated (declined) by 40 percent in terms of dollars, and marks had depreciated by 44 percent in terms of dollars. From the U.S. point of view, the dollar had appreciated (risen) by 66 percent and 80 percent respectively. Shortly after February, 1985, foreign currencies *in general rose* considerably against the U.S. dollar, at least until the spring of 1988.

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