Topic 10

Foreign exchange rates and trade

Learning outcomes

After studying this topic, you will be able to:

- define foreign exchange; and
- describe the impact of exchange rates on countries, society and individuals.

Introduction

The main time when you will see different types of currency is when you go on holidays abroad. Or perhaps you might know someone with a collection of different types of money from around the world?

Although we do not generally have cause to think specifically about foreign currency until we go abroad, that does not mean that it does not play a big part in our lives and our personal finances. Foreign exchange and international trade are key parts of a national economy. All countries have their own national currencies and each country buys goods from other countries.

In previous topics, you have learned about how the different parts of the economy and our own personal financial decisions are interdependent: what we earn and our choices about spending or saving are heavily influenced by the actions of government and by the economic cycle. The state of the economy and the choices that we make are further influenced by the value of the national currency (the pound sterling) and import–export business, more commonly known as 'international trade'. In this topic, you will learn more about what foreign exchange rates are and how they are set, as well as their impact on nations, society and individuals.

One of the main effects of the foreign exchange rate is on international trade (import–export business). It essentially involves buying things from, and selling things to, other countries around the world. The amount of imports that come into a country can affect the overall demand for national goods and services, as well as the money that flows out of the national economy when UK businesses pay overseas suppliers. Exports can increase national wealth by bringing more income into the country from overseas customers.

The closest that many of us might *seem* to come to international trade is going on holiday. However, simply a brief look at where your clothes are made, or where your food comes from, will show that you are buying goods that have been made or grown in different countries across the globe.

10.1 What is foreign exchange?

Foreign exchange can range from a tourist exchanging money at the airport to a multinational company investing billions in offices based in other countries. Other reasons why people might use foreign currency are to buy and sell things abroad (if they want to buy a holiday home in another country, for example) or to send money to family overseas.

With the rise of globalisation (ie businesses operating in many different countries), there has been a huge increase in the number of transactions made internationally, and the foreign exchange market has become the biggest financial market in the world. So what is it and what does it do?

'Foreign exchange' is buying and selling the currencies used in other countries. The foreign exchange (also shortened to 'forex', or 'FX') rate is the price that you pay for buying or selling that currency. For example, if you were going to the United States, you would need US dollars (USD, or US$) instead of pounds sterling (GBP, or £). If the exchange rate were 1 GBP = 1.67 USD, £100 would buy US$167.

There are different ways of expressing the different currencies when writing about them. As well as the accepted symbol for a currency, such as £ or $, there is an assigned abbreviation for each currency. This usually comprises a two-letter country code abbreviation and the first letter of the currency name. Table 10.1 shows the currency symbol and assigned abbreviation for a few of the most widely used currencies in the world.

Table 10.1 Examples of currency symbols and their abbreviations

Country	Currency	Symbol	Abbreviation
United Kingdom	Pounds, pence	£	GBP (Great British pound)
United States	Dollars, cents	$	USD (United States dollar)
European Union	Euros, cents	€	EUR (euro)
Japan	Yen	¥	JPY (Japanese yen)
Australia	Dollars, cents	$	AUD (Australian dollar)

It may sound strange that you have to buy money, but the reason why you have to buy currency is so that you can use the medium of exchange that is accepted in a particular country to buy goods and services there. For example, pounds sterling are not accepted in payment at most of the shops in the United States. So you must pay to convert one currency to another –

in this case, pounds to dollars – to be able to use your money in the country to which you have travelled.

The companies that buy and sell currencies buy foreign currency at one price and sell it at another price. The difference between the two prices pays for the companies' costs and gives them some profit.

Jacob Baker buys currency

Jacob

My partner and I are going on holiday to Spain, and we want to exchange £100 for euros before we travel.

Jacob goes to a bureau de change (the most common term for a currency broker) and sees that it will sell euros at 1.0552 and buy euros at 1.1645. This is the value of euros that it will exchange for £1. When Jacob gives the broker £100, he gets €105.52. This exchange is at the *sell* rate of euros to the pound.

While on their holiday, Jacob and his partner exchange more pounds for euros at the bank near to their hotel.

When Jacob returns from his holiday, he has €105 left and wants to change it back into pounds. The exchange rate is still the same, so the bureau de change gives him £90.17 back. This exchange is at the *buy* rate of euros to the pound.

- It cost Jacob £99.51 to buy €105 at the bureau's sell rate of £1 = €1.0552 (99.51 × 1.0552 = 105).
- Jacob gets £90.17 when the bureau buys back €105 at the buy rate of £1 = €1.1645 (105 ÷ 1.1645 = 90.17).

The difference is £9.34, which the bureau uses to cover its costs and to make a profit.

Let's consider the bureau de change and the reason for this difference in exchange rates a little more closely.

Bureaux de change

Although *bureau de change* is a French term, it is commonly used across Europe to mean a shop where customers can exchange currency.

A bureau de change is a profit-making business, and it plays an important role in the movement of currencies between different countries. It makes money in two ways.

- It may charge a particular commission (an extra payment for the bureau's services). This is a one-off flat fee that is usually paid at the start of the transaction. It is common, these days, to see signs saying 'No commission' at bureaux de change: many will not charge commission in an effort to get more business.
- It will calculate different prices for buying and selling currencies. This is a complicated process, because currency prices can change daily or even hourly, so the bureau generally sets the buy price slightly above the accepted rate and the sell price just below it. This helps to soften any change in price and means that the bureau can make some money from the transaction.

Although bureaux de change were originally found only in banks, they have now become large private enterprises and operate out of many different places, such as shops, travel agencies or airports.

10.1.1 Foreign exchange services

The main foreign exchange services that banks offer are:

- helping businesses to move large sums of foreign money, for example helping exporters who need to accept foreign currency payments and importers who need to pay in foreign currency;
- basic currency exchange, such as for customers who are going abroad on holiday;
- wire transfers, also called 'remittances', sending currency to a bank in another country, for example when migrant workers send money home; and
- foreign currency bank accounts for companies and individuals who get paid, and who want to make payments, in foreign currencies.

As we have seen, there are also specialised companies that offer some of these services, for example bureaux de change, which buy and sell currencies, and wire transfer companies, which send money abroad. Usage of some of these services (such as wire transfers) has increased over recent years, as a result of the prevalence of technology, and the higher numbers of people living and buying property abroad.

The widespread use of credit and debit cards means that people who are travelling can also withdraw local currency from any cash machine or bank, or pay with their card, and let the bank do the currency exchange for them. Most banks will charge a foreign transaction fee for this service.

Lian sends money to Hong Kong

Lian

I have a nephew in Hong Kong who recently turned 12 years old. I wanted to send him some birthday money, so I arranged a money transfer online with an international payments company. I paid in pounds and my nephew received Hong Kong dollars in his bank account. The company took care of exchanging the currency and I paid a transfer fee.

Discuss

Around 340 million European citizens use the euro in 19 countries (European Commission, no date).

What do you think are the advantages of using the euro for people who live and work in these countries?

10.2 The impact of fluctuating foreign exchange rates

Exchange rates change the more or less that people buy and sell a particular currency, through international trade, imports and exports, and by moving currency from one country to another. Because the exchange rate is constantly changing, a currency is either strong or weak in relation to others.

- A **strong** currency means that its value against other currencies is high, owing to high demand. This results in imported goods being relatively cheap and exports being relatively expensive. Cheap imports can make it difficult for local businesses to compete: they may have much higher costs than foreign suppliers and may be unable to make a profit at the price at which the foreign supplier is selling their goods. Exporters may find it difficult to sell their goods abroad, leading to economic hardship for countries that rely on exports to provide a large portion of their national income.

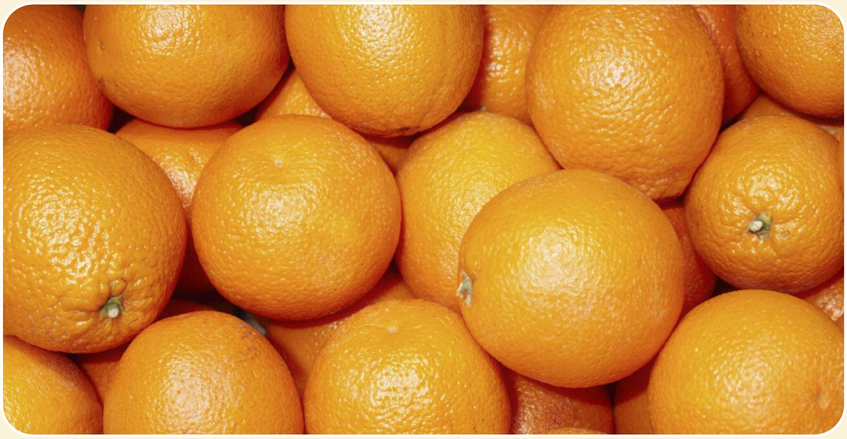
- A **weak** currency, on the other hand, increases demand for local goods and services, because imports become more expensive in comparison. This drives up employment and increases the gross domestic product (GDP) of the country.

The biggest impact of foreign exchange rates is in terms of international trade – or exporting and importing goods. Every country imports and exports, and has companies that conduct business overseas.

When a country or company imports something, it has to pay for that item in the currency of the country from which it is buying it. So it buys the currency; then it buys the item. This type of foreign exchange is generally done automatically through a bank.

eg

Example



If a UK company wants to import oranges from Florida in the United States, it will first have to buy the amount of US dollars that it needs for the deal; only then can it buy the oranges.

If a lot of people, organisations or governments are buying a particular currency (in order to pay for imports), the demand will push up the price of that currency. If a lot of different countries were to import goods from the United States, for example, the US dollar would be in demand and would be strong. When a currency is strong, people may buy more of it, either to keep hold of it to sell later or to buy goods from that country.

While it may seem that a strong currency is ideal, it is actually better to have a stable currency – ie one that is not too strong and has an exchange rate that does not change very much. A stable currency helps exporters and so helps the country in general. Foreign customers need to know what the cost of the goods they buy will be in terms of their own currency. If they are confident that the price will not change, they are likely to buy more – and this leads to a growing economy.

10.2.1 The impact on countries

Perhaps the biggest influence of foreign exchange rates on countries is on exports and imports. The direction of foreign exchange rates can make imports and exports more expensive or cheaper.

A strong currency means that imports will be cheap and exports will be expensive. This is because when the currency is strong, you do not have to pay as much to buy imported products, but it will be harder to sell goods overseas.

eg

Example

If £1 is worth US$3, then a packet of cookies worth $3 would cost the UK importer only £1.

If the exchange rate were not as strong and £1 were worth $2, then the same cookies would cost the UK importer £1.50.

So a strong currency is great for the importers and for those buying cheap imported goods. However, strong currencies can also mean:

- higher interest rates;
- lower export levels; and
- higher rates of unemployment, because local businesses are unable to compete with imported goods.

A strong currency can also be a problem for tourism into the country. People thinking of holidaying in a country with a strong currency will find everything very expensive, so they may choose not to go there at all.

Figure 10.1 Possible impact of an increase in currency value

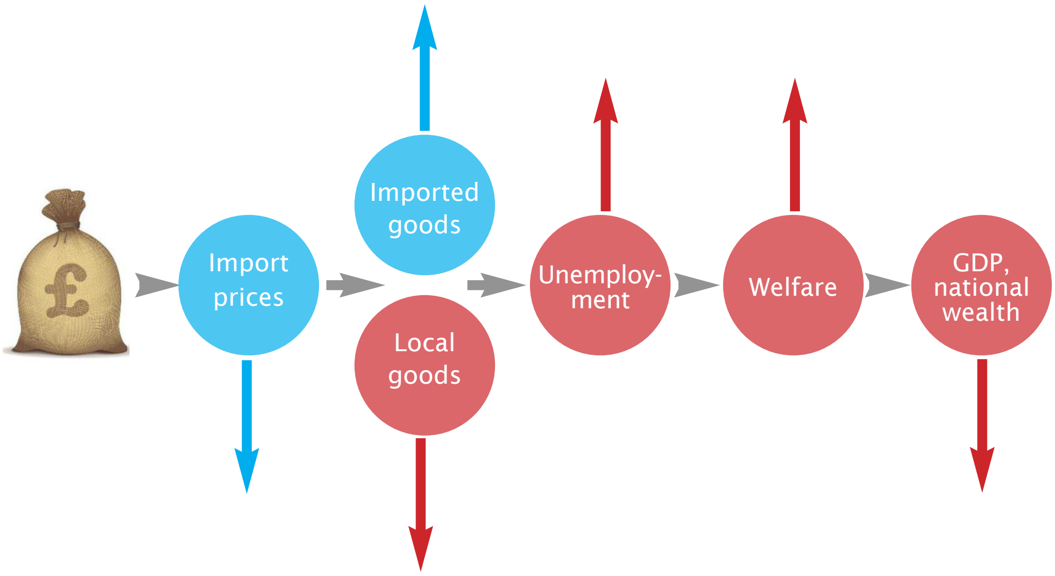


Figure 10.1 illustrates that when the value of a currency increases relative to other currencies, imported goods become cheaper (for example if £1 buys more Chinese yuan, Chinese clothes become cheaper for British companies to import). Local businesses that sell the same type of goods make fewer sales because people prefer to buy the cheaper imports.

For example, if clothes imported from China are much cheaper than clothes made in England, many people will prefer to buy the imported clothes. This means that local businesses will make less money and may have to make some staff redundant. Unemployment increases and so does the welfare bill for the benefits that are paid to support the jobless. National wealth falls because businesses are making less profit and paying less tax to the government. The government also gets less tax from individuals, because more people are unemployed.

However, when a currency gets weaker (known as 'devaluation'), the opposite occurs. Imports become more expensive, because it takes more pounds to buy products from other countries, whereas exports become cheaper.

Example

Suppose a company exports British raincoats to Australia. When the pound is weak compared to the Australian dollar, the raincoats are cheap for Australians to import. The British company will sell a lot of raincoats to Australia. If the pound gets stronger against the Australian dollar, Australians will find the raincoats more expensive and might decide not to buy them any more (Ruddick, 2014).

Discuss

A company in Dublin has ordered some pottery from Richard Baker. Dublin is in Ireland, which uses the euro as its currency.

When would be the best time for Richard to sell the company his pots: when the pound is strong against the euro or when it is weak?

10.2.2 The impact on society

As well as having an impact on the country as a whole, foreign exchange has a specific impact on society in terms of imports and the local goods that compete with imports.

'Import-competing' goods are those that are made locally and which also have an import equivalent. In the UK, chocolate is both made locally and imported from other countries; for example, Thorntons' chocolate is made in Derbyshire, while Hershey's chocolate is made in the United States.

With the rise of multinational companies and offshore manufacturing (ie manufacturing overseas), exclusively locally made and locally owned big-name products are harder to find. Most locally made products are either components of a larger product (such as USB connectors for computers) or niche markets (such as socks or buttons). With these goods, manufacturing may take place in Britain, but many raw materials have to come from abroad. If competing imports are cheaper, then people will not buy the goods made within the country, affecting local jobs and income.

The impact that this has on a community is both economic and social. Many of the social implications also have corresponding economic implications.

The following case study explains the social impact of a factory closing down as a result of decreasing sales.

Case study: Broken communities

A British factory, based in the UK, employs 7,000 workers manufacturing USB connectors for export.

After an increase in the exchange rate, fewer people abroad have been importing the USB connectors, because it has become more expensive to buy them. This means that profits have decreased to a point at which the company can no longer make money – and the company has been forced to close down the factory.

This has resulted in large-scale unemployment in the area and a corresponding rise in welfare claims. Many families have been left without an income that is sufficient to pay their usual bills and are now unable to afford to repay their mortgages. In order to save money and look for work, people are starting to move out of the area and the community is suffering because the young people are the first to leave.

The decrease in population – and the fact that people have less money – means that local businesses are also losing money, because there is less money to spend in the area.

In this case study, the increase in the exchange rate has led to the closure of one factory, which has resulted in a decrease in well-being across the whole community.

As you can see, a weak currency can lead to local – as well as national – hardship. Increasing sales of imported goods can mean that local businesses suffer. This means that they may lose money and have to reduce their workforce through cutting jobs. This, in turn, impacts on families and the community as a whole.

Buy British

The main idea behind the 'Buy British' initiative is to encourage people to buy British-made and British-owned products, with the aim of ensuring that as much money as possible remains in the UK economy, boosting business and increasing employment (BuyBritish.com, 2008).

Encouraging the 'Buy British' ideology can mean that when the exchange rate increases (making imports more attractive owing to their relatively low prices), people may still spend their money on locally made British items.

This could then protect the British economy from the negative effects of an increasing exchange rate.

10.2.3 The impact on individuals

You might not think that you care about the difference between yen and dollars. However, it may be clear by now that if foreign currency exchange affects countries and societies, then it must also affect individuals.

Some of the effects have been outlined already, such as unemployment caused by businesses losing money and the subsequent need to rely on the government for an income through claiming benefits. This reduction in income means that people do not have as much money to save or to spend.

However, a strong currency can also work in favour of individuals.

- Costs may reduce, as goods fight to remain competitive in the market. This means that because products are imported at cheaper prices, the local products must also reduce their cost if they are to compete.
- A strong currency can also be good for people going on holiday. When they exchange a strong currency against a weaker one, they will get more of the foreign currency – and will therefore be able to holiday at cheaper prices than if their own currency were weak.

Case study: Sophie Baker is going on holiday

Sophie

I'm planning a holiday with some friends from school. In trying to decide where to go, we've looked at the exchange rates of different countries and what basic items are worth, so that we can work out how much money we might have to spend.

I realised that, in a few of the countries we're considering, the local cost of living is lower than in the UK, so we'll find that food and drink is quite cheap when we get there. For example, I looked up the price of a bottle of water in Thailand: a bottle that costs £1.20 here costs the equivalent of only 18p there! So, when we plan our holiday money, we have to take into account local prices, as well as the currency exchange rate.

This means that we won't need to save as much spending money for the holiday as we'd planned and that we can save for other items, like new clothes, as well.

Summary

Finally, we can recap what we have learned in this topic.

- In this topic, we have learned about the main features of foreign currency exchange, and that it can have a significant impact on nations, society and individuals.
- Foreign exchange rates exist in all countries and are constantly changing. The theory is simple: you pay money to buy the currencies of other nations. However, in practice, this has wide-reaching effects and can mean that economic conditions in a country either improve or get worse, simply on the strength of the national currency.
- There are different impacts on the economy, based on how weak or how strong the national currency is.
  - If the currency is strong, exports will be expensive and imports will be cheap. Cheap imports can then lead to fewer sales for local businesses, which may result in job losses, reduced income for the employees that remain and a greater benefits bill for the government, as well as social costs.
  - A weaker currency will mean the opposite – ie that exports are cheap and imports are expensive. The local economy will grow, but this could cause prices to increase and lead to all the issues that come with rising inflation (as described in Topic 8).

- Countries go up and down in the economic cycle (see Topic 9), and at each point there are different positives and negatives for the citizens who live in that country.

Thinking points

- What would it be like if the world were to have only one currency?
- A person working for an international company is paid in pounds sterling, but is based at the office in the United States. What will be the impact on that person's budget of the exchange rate between pounds and US dollars changing?
- Do you think that companies should buy their stock from a cheap foreign supplier, so that they can charge British customers low prices? Or should they buy from British suppliers and charge customers more?

Key terms

Bureau de change – a business that deals in currency exchange.

Commission – an amount charged by currency exchange services as a flat fee for the service of buying or selling foreign currencies.

Currency – the money used in a particular country.

Currency broker – a person or business who deals in all kinds of currency exchange.

Currency exchange – changing one currency for another; buying and selling foreign currency.

Devaluation – the situation in which the value of something goes down.

Exports – goods or services that are sold outside a country.

Foreign currency – the money used in a country other than your own.

Foreign exchange rate – the price of exchanging one kind of currency into another.

Imports – goods or services that are bought abroad and brought into a country.

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