

Foreign Exchange

- Foreign exchange is the currency of another country that is needed to carry out international transactions
- A country runs a deficit in its current account when the amount of foreign exchange that country gets from exporting goods and services and from receipts of unilateral transfers falls short of the amount needed to pay for its imports and to make unilateral transfers

Foreign Exchange

- The additional foreign exchange required must come from a net capital inflow
- If a country runs a current account surplus, the foreign exchange received from selling exports and from unilateral transfers received exceeds the amount required to pay for imports and to make unilateral transfers

Exchange Rate

- The exchange rate is the price of a unit of one currency required to purchase a unit of another currency
 - Determined by the interaction of the households, firms, private financial institutions, governments, and central banks that buy and sell foreign exchange
 - Fluctuates to equate the quantity of foreign exchange demanded with the quantity supplied
 - Foreign exchange market incorporates all the arrangements used to buy and sell foreign exchange

Exchange Rate

- The price, or exchange rate, of the US \$ in terms of the RM is the number of RM required to purchase one US \$.
- An increase in the number of RM needed to purchase a US \$ indicates a weakening, or a depreciation, of the RM.
- A decrease in the number of RM needed to purchase a US \$ indicates a strengthening, or an appreciation of the RM.

Demand for Foreign Exchange

- Malaysia residents need US \$ to pay for goods and services produced in US.
- The demand curve for US \$ the inverse relationship between the RM price of the US \$ and the quantity of US \$ demanded, other things constant.
- The Demand for US \$ depends on
 - Incomes and preferences of Malaysian consumers
 - The expected inflation rates in Malaysia and US
 - The US price of goods in US
 - Interest rates in the U.S. and Malaysia

Demand for Foreign Exchange

- In the aggregate, the lower the RM price of foreign exchange, other things constant, the greater the quantity demanded.
- A drop in the RM price of foreign exchange, in this case the US \$, means that fewer RM are required to purchase each US \$ → prices of US goods become cheaper.

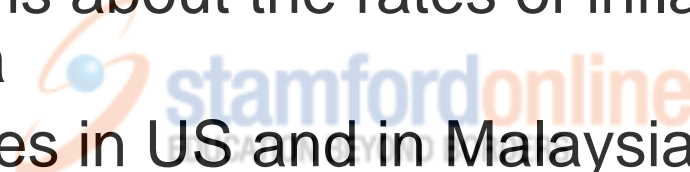
Supply of Foreign Exchange

- The positive relationship between the RM-per-US \$ exchange rate and the quantity of US \$ supplied in the foreign exchange market implies an upward-sloping supply curve.



Supply of Foreign Exchange

- The supply curve is drawn assuming other things constant
 - US incomes and preferences
 - Expectations about the rates of inflation in US and in Malaysia
 - Interest rates in US and in Malaysia



Exchange Rate

- This demand and supply interact each other and market rate of exchange rate has been established. The exchange rate is called a flexible exchange rate
 - Flexible, or floating, exchange rates adjust continually to the myriad forces that buffet the foreign exchange market
 - Government officials usually have little direct role in foreign exchange markets