

About.com Economics

What Determines an Exchange Rate

From [Mike Moffatt](#), former About.com Guide

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What Determines Exchange Rates:

If I visit an exchange rate site such as [XE.com](#), it will tell me that 1 U.S. dollar is trading for 0.67 euros. But how is this exchange rate determined? What gives the U.S. dollar this value when priced in euros?

Short Run Exchange Rates are Determined by Supply and Demand:

Like any other price in our economy, exchange rates are determined by supply and demand - specifically the supply and demand for each currency. But that explanation is almost tautological - we need to know what determines the supply of a currency and the demand for a currency.

What Determines the Demand for a Currency?:

The supply of a currency on a foreign exchange market is determined by the following:

- Demand for goods, services and investments priced in that currency. If I want to buy Canadian bonds or Canadian maple syrup, then I will need Canadian dollars to do so. If total expenditures, by non-Canadians, on these items rise, the demand for the Canadian dollar will rise.
- Speculators. If I believe, for whatever reason, the Canadian dollar will rise in value in the future, I will want to buy more Canadian dollars today.
- Central banks - Occasionally central banks will buy up a foreign currency to affect the exchange rate.

What Determines the Supply of a Currency?:

The supply of currency is affected by the following:

- Demand for goods, services and investments priced in **a different** currency. If I want Canadian maple syrup, I will need Canadian dollars. To get Canadian dollars, I will have to supply a currency in return, such as yen or U.S. dollars.
- Speculators. If I believe, for whatever reason, the Canadian dollar will fall in value in the future, I will start to sell off my Canadian dollars today (that is, supply them to the market).
- Central banks through increases in the money supply. See: [Why Not Just Print More Money?](#)

What Should The Currency Be Worth?:

If speculators can affect both the supply and demand for a currency, they can ultimately affect the price. Thus does a currency have an intrinsic value relative to another currency? Is there a level the exchange rate should be at?

It turns out there is at least a rough level to which a currency should be worth - please see [A Beginner's Guide to Purchasing Power Parity Theory](#). The exchange rate, in the long run, needs to be at the level which a basket of goods costs the same in two currencies. Thus if a Mickey Mantle rookie card costs \$50,000 Canadian and \$25,000 US, the exchange rate should

be 2 CDN = 1 US.

Want to Know More About Exchange Rates?:

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