Depreciation and appreciation

- **Depreciation** is a decrease in the value of a currency relative to another currency
  - \(0.8/€ \rightarrow 1/€\) means that the pound has depreciated relative to the euro
    - less valuable and can buy fewer Euros.
    - imports more expensive (cost of Renault £20,000 \(\rightarrow\) 25,000 \(\times\) 1 = £25,000)
    - exports cheaper

- **Appreciation** is an increase in the value of a currency relative to another currency
  - \(0.8/€ \rightarrow 0.6/€\) means that the pound has appreciated relative to the Euro
    - pound more valuable
    - imports cheaper (Renault £20,000 \(\rightarrow\) 25,000 \(\times\) 0.6 = £15,000)
    - exports more expensive

Dollar/euro exchange rate

Want to explain major (not daily) movements in this:

Periods of dollar appreciation and depreciation

Foreign exchange market

Major factor influences the demand for currencies is:

- **Rate of return** - the percentage change in the value of currency deposits
  - determined by:
    - interest rates that the assets will earn in each currency
    - expectations about appreciation or depreciation of currencies
    - investors want to hold currency offering highest overall return

- Other factors, e.g. risk and liquidity, less important
Effect of expectations
Changes in expectations self-fulfilling - increase in $E^e_{t+1}$ increases expected returns which causes appreciation

Interest rate determination
Interest rates are the price of holding liquid assets (money) rather than higher-yielding, less liquid assets
- Money is a liquid asset used as means of payment
  - monetary assets
    - currency in circulation
    - current account deposits
    - debit card accounts
    - savings deposits
  - nonmonetary assets
    - bonds
    - loans
    - stocks
    - property
- Determined by supply and demand for money in national money market

Demand for money
Demand for money determined by:
- Interest rates/expected rates of return
  - interest rate on nonmonetary assets is opportunity cost of holding money
    * higher opportunity cost $\rightarrow$ lower demand for money
- Prices
  - higher average prices means more money needed to undertake transactions
    * higher prices $\rightarrow$ higher demand for money
- Income
  - more goods and services bought at higher incomes, so more money needed for transactions
    * higher GNP $\rightarrow$ higher demand for money
- Aggregate money demand: $M^d = P \cdot L(R, Y)$, or $\frac{M^d}{P} = L(R, Y)$