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 $25,000 * 0.8 = £20,000 \longrightarrow 25,000 * 1 = £25,000$)
    - 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 $\longrightarrow 25,000 * 0.6 = £15,000$)
    - Exports more expensive

Dollar/euro exchange rate

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

Periods of dollar appreciation and depreciation

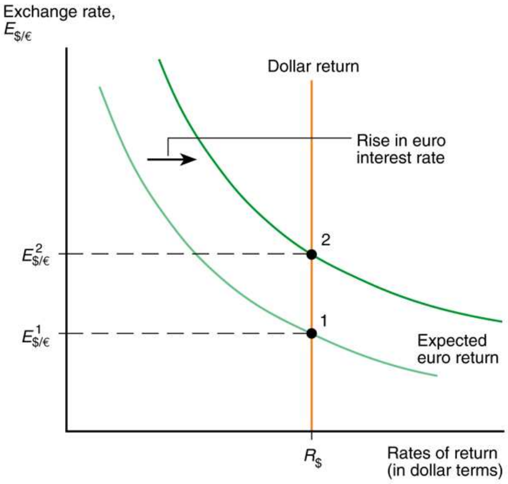
Foreign exchange market

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 $E^e_{\$/€}$ increases expected returns which causes appreciation



Interest rate determination

Interest rates are the price of holding liquid assets (money) rather than higher yeilding, 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:

1. Interest rates/expected rates of return
   - interest rate on nonmonetary assets is opportunity cost of holding money
     - higher opportunity cost $\longrightarrow$lower demand for money
2. Prices
   - higher average prices means more money needed to undertake transactions
     - higher prices $\rightarrow$ higher demand for money
3. 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: $M^d = P * L(R, Y)$, or $\frac{M^d}{P} = L(R, Y)$