Economics MASTERCLASS

Exchange rates

A sound knowledge of the rate of exchange between two currencies is imperative when taking overseas property investment decisions. John Farrell takes a look at the pound in relation to its major competitors.

The exchange rate is defined as the price of one currency in terms of another and is a strong indication of the strength of a country's economy. Currencies are traded around the world in a truly global market and the scale of the daily trading in the world's foreign exchange markets is vast.

In February 2006 the bilateral exchange rate of the pound was in a healthy state. Against the dollar £1 would get you $1.95, whereas against the euro £1 would buy €1.48. However, exchange rate prices are expressed in various ways and knowledge of this will aid any investment decision.

The spot exchange rate is the actual exchange rate for a currency at a particular moment in time. This is determined by the FOREX market on a minute-by-minute basis and is usually expressed as a bilateral exchange rate, e.g. £1 = $1.95.

The forward exchange rate involves two parties agreeing a rate of exchange for a transaction that will take place in the future. Firms wanting to reduce the risk of exchange rate volatility often buy their currency at the forward rate for delivery in three or six months' time. This is especially important on a floating exchange rate (supply and demand) system, which is the case with the UK.

The effective exchange rate, or sterling index, has its base in January 2005 and is a weighted index of sterling's value against a basket of international currencies. By February 2006 the index was 6% above its base, indicating that the pound was then stronger than a year previously.

In London alone the sterling value of currency dealing is around £550 billion per day, which is roughly half the total value of UK national output in a year. The most traded currency on the London FOREX market is the US dollar followed by the euro and pound sterling. London is now the biggest centre for foreign exchange trading in the world.

There are several reasons for this. London enjoys the advantage that it straddles the time zones for the Asian and US markets. London currency dealers have benefited from a surge in foreign takeovers of UK companies, speculative activity in pound sterling and the rapid expansion of London-based hedge funds (private investment companies), contributing to the fast growth of trading in foreign exchange.

Such is the scale and volume of currency dealing, central banks such as the Bank of England have very little impact on the market through official buying and selling to achieve a given exchange rate target or movement. However, changes in short-term interest rates can affect the value of the currency, which is the main reason why the pound has strengthened in the last year against the dollar.

In a floating exchange rate system the market value of a currency is determined by the twin forces of supply and demand. When a currency is in strong demand it will appreciate (strengthen) in value, say from £1 = $1.50 to £1 = $1.90. In contrast, when there is a large-scale selling of a currency it will depreciate (weaken), say from £1= $1.50 to £1 = $1.30.

The demand for sterling (pounds) in the FOREX market comes from four main sources:

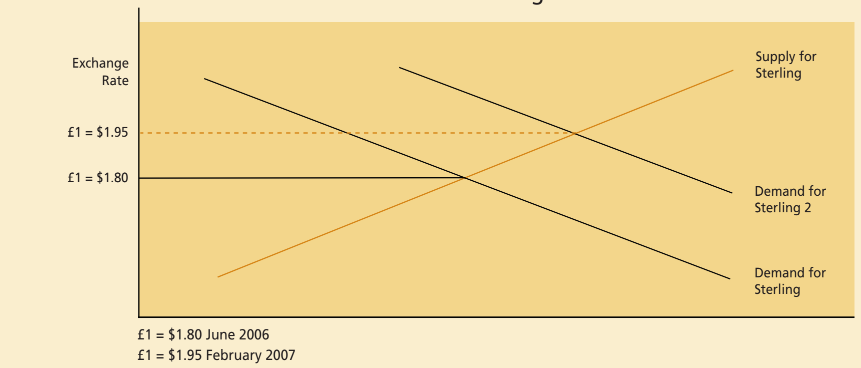
1. The demand for UK goods and services exported overseas creates an inflow of currency that needs to be turned into sterling. Therefore £1,000-worth of UK goods at an exchange rate of £1 to $1.50 cost the American $1,500. However, at £1 to $2 the same goods cost $2,000. Therefore, the lower the value of the pound, the cheaper UK goods and services become. At the moment UK exporters are finding it difficult as the pound is nearer to $2 than $1.50.
2. Foreign investment flows into the UK from multinationals and global corporations. In the last 25 years the UK has been the biggest recipient of Foreign Direct Investment into Europe and this has created an increase in the demand for pounds.
3. Market speculators (people who look for short-term gain on currency) who decide they want to purchase pounds in the expectation of making a financial gain. In the past year most speculators would have assumed that the pound would rise in value and therefore they would have been buying pounds.
4. The Bank of England can use our foreign currency reserves, which are mainly euros and dollars, as the Chancellor sold off our gold reserves for euros in the late 1990s. The bank can purchase sterling using its reserve currencies, but this official intervention is no longer effective due to the size of the daily currency transactions.

The supply of sterling (pounds) on the foreign exchange markets occurs for the following reasons:

1. UK consumers and firms buy foreign goods and services, which are then imported into the UK. We sell sterling in the FOREX market in order to buy these imports. Therefore $2,000-worth of goods in the USA at £1 to $2 will cost the British consumer £1,000, whereas at £1 to $1.50 they will require 33% more pounds, making the price £1,333.

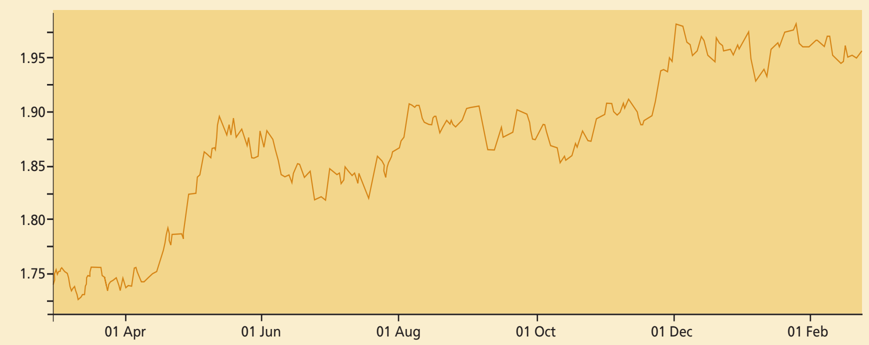
   Even marginal appreciations in the pound will make a significant difference to the final price. For example, when purchasing overseas assets such as a European property for €150,000 at an exchange rate of £1 = €1.49, the cost would be £100,643, whereas at £1 = €1.50 the final price is £100,000. Therefore the higher the value of the pound, the cheaper overseas assets become in pounds sterling.
2. Investment capital flows out of the UK by companies seeking a better rate of return. This has been offset by Foreign Direct Investment into the UK.
3. Speculators sell pounds for another currency. They have not been doing this in the past year; rather they have been selling dollars.
4. Other central banks go into the FOREX market and sell pounds to buy other foreign currencies.

Pound / Dollar Exchange Rate



In the above diagram we can see the equilibrium exchange rate between the pound and US dollar is where supply and demand is equal. If there is an increase in demand (all else being equal) the pound will rise in value.

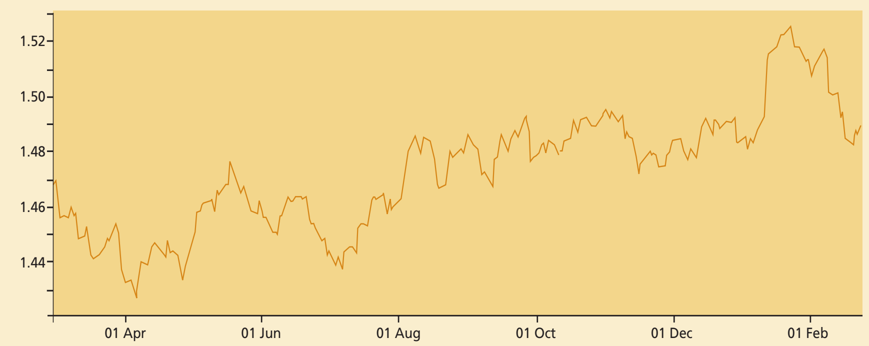
Pound Sterling / US Dollar



SOURCE: BBC News

In the past year the pound has appreciated more significantly against the dollar than the euro. Below we can see the pound has been in a narrower trading range against the euro.

Pound Sterling / Euro exchange rate over past 12 months



SOURCE: BBC News