Fin-Ed Centre

FINANCIAL EDUCATION AND RESEARCH CENTRE

Understanding your financial world

Foreign exchange markets and foreign exchange rates

The foreign currency earned by exports and the capital inflows from overseas must be converted to New Zealand dollars to be able to be used in New Zealand. Conversely, New Zealand dollars must be converted into the relevant foreign currency to pay for imports and capital outflows. This is done through foreign exchange markets and exchange rates.

Exchange rate

The price at which one currency is exchanged for another. Exchange rates can be fixed (against another currency or basket of currencies) or floating.

(adapted from Stewart and Rankin, 2008, p.402)

All foreign exchange is done through foreign exchange markets.

Foreign exchange market

The foreign exchange market is the international market where the exchange of one currency for another currency takes place. All currency exchanges take place in the foreign exchange market.

(adapted from Stewart and Rankin, 2008, p.404)

A change in the exchange rate can have a significant impact on economic activity. A change in the New Zealand dollar exchange rate will cause the price that foreigners can buy and sell New Zealand exports to either rise (when the New Zealand dollar appreciates and foreigners need more of their currency to pay for their New Zealand goods and services) or fall (when the New Zealand dollar depreciates and foreigners need less of their currency to pay for their New Zealand goods and services). When the New Zealand dollar appreciates, New Zealanders need less of their currency to pay for their foreign goods and services so imports are cheaper. On the other hand, when the New Zealand dollar depreciates, the cost of imports for New Zealanders is higher.

Operation of the foreign exchange market

For an explanation of how the foreign exchange market works see the Powerpoint presentation: 'How the foreign exchange market works'.

Setting the exchange rate

New Zealand has a floating exchange rate. The rate is established by the demand and supply of the New Zealand dollar (also known as the Kiwi dollar – shortened to Kiwi). Demand for the Kiwi is created by exporters who have sold their goods and services for foreign currency e.g. Australian dollars and want to convert the foreign currency into New Zealand dollars to pay their workers and other costs. The supply of New Zealand dollars is created by importers who want to buy foreign currency to pay for their imports (by selling Kiwi). The exchange rate is set when there are willing sellers and willing buyers of Kiwi at rate that both parties are happy with. The supply and demand for Kiwi is not only influenced by exporters and importers. The market makes no distinction between why there is a need for Kiwi or foreign currencies. Investment money, borrowing, and other forms of cross border financial transactions also affect the demand and supply of Kiwi. In an open foreign exchange market such as New Zealand's the demand and supply of Kiwi (and other currencies), and therefore the exchange rate, changes minute-by-minute.

An increase in demand for Kiwi, or a decrease in supply (or both) will cause the New Zealand dollar to appreciate. A decrease in demand for Kiwi, or an increase in supply (or both) will cause the New Zealand dollar to depreciate.

Appreciation of currency

A rise in the price of one currency compared to other currencies.

Depreciation of currency

A fall in the price of one currency compared to other currencies

(adapted from Stewart and Rankin, 2008, p.408)

Adapted from Stewart, J. and Rankin, K. (2008). *Economic concepts and applications: The contemporary New Zealand environment*, 4th ed. Pearson: Auckland, New Zealand