Interest rates and exchange rates

Interest rates
Represent the cost of borrowing money and the reward offered to savers. Interest rates are determined by the Monetary Policy Committee within the UK. This is an independent body which sets interest rates to achieve a set inflation target.

Interest rate increases

Effects include:

- households are more likely to save and less likely to spend. This will affect income elastic goods more than income inelastic, e.g. the demand for shopping goods are likely to be more affected than the demand for convenience goods.
- households' discretionary income is likely to fall as more money is used to repay mortgages and loans (discretionary income = income after tax and regular bills).
- firms are likely to reduce their stocks because money tied up in stocks represents a greater opportunity cost.
- debtors will want to hold on to their money to earn interest and are likely to delay payment.
- creditors will want their money more quickly.
- because of an increased desire to save in the UK the exchange rate might increase as demand for pounds from abroad increases.

Interest rates fall

Effects include:

- may increase demand (cheaper for firms and households to borrow)
- may reduce costs (lower interest payments)
- may reduce the exchange rate (less demand for pounds from overseas)

Impact on firm depends on:

- how sensitive its demand is to interest changes, e.g. demand for salt is not sensitive to interest rates; demand for cars is more sensitive as people borrow to buy cars
- extent of interest rate fall

Exchange rates

The exchange rate is the price of one currency in terms of another, e.g. it may cost 2 dollars to buy one pound.

In a free floating exchange rate system the value of the pound is determined by supply and demand for the currency. Demand for pounds (or sterling) is the demand to buy pounds with other currencies. The supply of pounds (or sterling) depends on the desire to change pounds into another currency.

If demand increases the price is likely to increase. If supply increases the price is likely to fall as more are available.

Demand for pounds may increase because of:

- more demand for UK goods and services
- greater desire to save in the UK (e.g. higher interest rates)
- more tourism to the UK
- speculators who believe that the pound will rise in the future so buy now

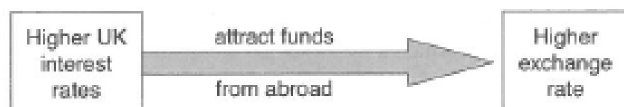
Supply of pounds may increase because of:

- greater demand for overseas goods and services
- greater desire to save abroad
- more tourism abroad
- speculators who believe that the pound will fall in the future so sell now

There are many different exchange rates because the pound is exchanged for many other currencies, e.g. the yen, the deutschmark, the franc. The pound will have a price against each of these currencies.

Effective exchange rate: shows the value of a pound against a number of other currencies. It is calculated as a weighted index; each currency has a different weight according to its relative importance in trade with the UK.

A high or strong pound: means the pound is more expensive, i.e. it costs more in terms of foreign currency. This makes UK goods/services more expensive in foreign currencies but because a pound can be changed for more foreign currency it becomes cheaper to buy imports in pounds.



Interest rates and exchange rates continued

Increase in the value of the pound (i.e. an appreciation of the exchange rate)

Effects include:

- increases price of UK goods and services abroad in terms of foreign currency; demand for UK goods and services is likely to fall. The extent of the fall depends on how sensitive demand is to price (price elasticity of demand). However, some firms may decide not to allow an increase in price overseas and are willing to accept lower profit margins instead.
- imports become cheaper in pounds. May reduce input costs for UK firms.
- may make it more difficult for domestic firms to compete against foreign competitors whose goods are relatively cheaper.

Depends on:

- how much the pound has gone up and for how long
- which currencies it has increased against

Appreciation and depreciation

An increase in the pound is called an **appreciation;** it means the pound is stronger. e.g. if the pound increases in value from £1:$1 to £1:$2 it has appreciated.

A fall in the pound is called a **depreciation;** it means the pound is weaker. e.g. if the pound falls in value from £1:$2 to £1:$1 it has depreciated.

Government and the exchange rate:

Government can increase the value of the pound by:

- buying pounds with foreign currencies through the Bank of England
- increasing interest rates to make pounds more attractive to would-be savers from abroad, although now interest rates are set independently by the Monetary Policy Committee

Exchange rates and business opportunities

- Strong pound: can buy materials and components from overseas for a lower price in pounds
- Weak pound: can sell overseas for lower price in foreign currency (or maintain price and have bigger profit margins)

Reaction to a strong pound

A firm might:

- rationalise; try to cut costs
- accept lower profit margins by keeping price the same overseas to maintain sales
- try to buy in more components from overseas to benefit from low price in pounds
- seek new export markets where the pound is not so strong
- diversify into less price sensitive products

Exchange rate systems

In a fixed exchange rate system the government intervenes to keep the price constant or within a band. In a floating exchange rate system the currency is determined totally by supply and demand of that currency.

European Monetary Union (EMU)

Single currency area in which member countries use the euro.

Benefits to members:

- reduced transaction costs
- easier to compare prices
- removes exchange rate risk

Note: these benefits only occur when trading with other 'euro' countries.

Problems include:

- transition costs e.g. amending price lists when you first join
- greater price transparency may make it difficult for some firms to compete.
- interest rates will be set based on monetary conditions throughout the euro-zone; may adversely affect firms in particular regions at any moment.
- firms will no longer benefit from favourable changes in the currency, e.g. a depreciating exchange rate.

The impact of the euro

Depends on:

- amount of trade a firm does within the euro-zone
- value at which a currency joins, e.g. how many francs to the euro?

Inflation

Inflation is a persistent increase in the general price level. It is usually measured by the **Retail Price Index (RPI)**. The RPI measures the cost of living. It is a weighted index; the weights reflect the relative importance of different goods to the average household.

Causes of inflation:

Include:

- demand pull – too much demand for the number of goods. In this situation firms are able to increase their prices and profit margins. Due to high demand stocks are likely to be falling.
- cost push – an increase in costs (e.g. wages or materials) forces producers to increase prices or accept lower profit margins, e.g. in the mid to late 1970s prices increased due to sudden increases in oil prices, which increased costs.

The impact of inflation on firms

- May reduce the real value of debt
- May increase value of assets on the balance sheet
- May be able to increase own prices in line with inflation
- Planning can be more difficult (e.g. due to uncertainty over prices)
- May lead to disputes over wage increases (as employees want pay increases at least in line with inflation)
- Can lead to uncompetitiveness abroad (depending on what is happening to the exchange rate and prices overseas).
- Causes menu costs - the costs of changing, e.g. menus, brochures, slot machines.
- May lead to wage-price spiral.
- May lead to damaging counter inflation policies (e.g. higher interest rates).

Depends on:

- whether the firm can increase prices in line with increasing costs
- how much incomes are increasing
- rate of inflation
- cause of inflation (demand pull or cost push)
- whether anticipated or not
- what is happening to inflation in other countries.
- what is happening to exchange rates.
- the cause (e.g. is it demand pull or cost push?)

Inflation

- Does not mean all prices all rising; simply that there is a sustained increase in the general price level.
- Does not necessarily mean people cannot afford items; this depends on what their incomes are doing. Prices are generally much higher now than ten years ago but we still have more purchasing power because incomes have increased even more.
- Is not necessarily a bad thing from a producers' perspective; it may signify high levels of demand and a shortage within the market.

Controlling inflation

- Increase interest rates to deter spending
- Restrict lending to deter spending

} to reduce demand pull inflation

- Increase exchange rate to make imports cheaper
- Incomes policies – Government limits pay increases (this only tends to work in the short term as employees resist constraints on pay rises)

} to reduce cost push inflation

Deflation

Occurs when prices are falling.
This may be because:

- demand is falling
- costs are falling

If deflation is due to falling levels of demand this might mean

- falling sales
- the need to rationalise
- redundancies

However if it is due to lower costs this may make the firm more competitive overseas. This could lead to more growth and more jobs.

Wage price spiral:
Prices increase (e.g. due to too much demand), employees demand higher wages, this increases costs so prices increase and so on.

Effect of a firm increasing its prices

Depends on:

- what other firms are doing
- how sensitive demand is to price
- what is happening to income levels. If incomes are rising faster than prices the standard of living is actually increasing
- what is happening to the exchange rate (if the firm exports)