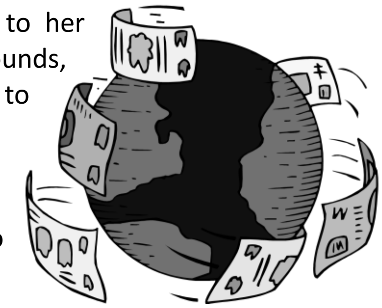

Simone, a 21-year-old veteran vagabond, peered into her wallet. Next to her passport and train tickets was her money. She pulled out her collection of pounds, rubles, kroner, yen, pesos, and euros. Simone looked up, confused. She tried to remember how she came to possess these currencies.

Simone is not alone. The world of foreign currencies often seems confusing. Not only are many of the names unfamiliar, but some travelers also want to know what each is worth in terms of U.S. dollars.

Because all of these currencies are money, they all serve the same functions. Money is a medium of exchange, a store of value, and a measure of value. As a medium of exchange, money can be used to purchase goods and services. As a store of value, money can be saved to use in the future. As a measure of value, money allows us to express the price of things. We can say a car costs so many dollars while a DVD player costs many fewer dollars.

Now to a basic question. How do we know what a foreign exchange rate is? How much is any currency worth in terms of other currencies? The simple answer is that a currency is worth whatever people are willing to pay for it. This is a case of supply and demand interacting in a market to establish a price for currency. If there is little quantity demanded for the country's currency, or a great quantity available for foreigners to buy, the money will be worth less on the foreign exchange market. If there is a high quantity demanded or only a small quantity supplied, then it will be worth more on the foreign exchange market.

For example, when Americans increase their purchases of imports, more U.S. dollars are sent abroad or are exchanged for foreign currencies in order to pay for the imported goods. As the supply of dollars to foreigners increases, the dollar tends to be worth less in terms of other currencies. Under such conditions we say the dollar *depreciates*, or weakens. The same general analysis holds true for the currencies of other nations. If a currency increases its worth in terms of other currencies, we say it *appreciates*.

Currency values are established (and exchanges of currencies occur) in foreign exchange markets. These markets exist at banks, at the offices of foreign exchange dealers, and other places where one country's currency or checks can be exchanged for those of another country. But the greatest amount of foreign exchange activity takes place by telephone, electronically, or by other rapid means of communication used by commercial banks, businesses, and others who deal in large amounts of foreign exchange.

Foreign exchange values can change every day – most days by small amounts; some days by enough to make a difference to the people or businesses that are converting (exchanging) one currency into another. In the longer run, changes of great magnitude can occur. In the 1990s the value of foreign currencies, in general, fell a great deal against the U.S. dollar. Looking at the situation the other way, the dollar rose a great deal against foreign currencies.

In the 21st century, it will be interesting to see how "strong" the U.S. dollar remains relative the other currencies (it hasn't lately). When the euro was introduced in January 1999, one U.S. dollar could buy 0.90 of a euro. By 2002, the U.S. dollar could buy 1.10 euros. Today, the dollar will only buy 0.84 euro. As the euro becomes more popular as a currency (greater demand), its value may continue to grow compared to other currencies. In addition, the spending habits of Americans on imports has provided an excess supply of U.S. dollars in the world market, causing the U.S. dollar to become weaker in relation to other currencies.

QUESTIONS FOR DISCUSSION

1. What are the three functions of money?

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2. The value of any currency is determined by the ________________ of it and the ________________ for it.

3. When a currency decreases in value, we say it ________________. When a currency increases in value, we say it ________________.

4. What do we call the places or means of communication by which currencies are traded and the value of one country's currency is established in terms of other currencies?

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5. Assume the United States makes new products that citizens of other countries buy in large quantities. All other things being equal, what will happen to the value of the U.S. dollar in terms of foreign currencies? (Hint: think about the supply and demand for the dollar)

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6. Assume the number of U.S. citizens traveling to foreign countries greatly increases. These Americans are spending a lot of U.S. dollars overseas. All other things being equal, what will happen to the value of the U.S. dollar in terms of foreign currencies?

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7. Imagine a situation in which there is an increase of thousands of U.S. citizens (tourists, business representatives, and government officials) who choose to visit Japan. All of these visitors, arriving in the Tokyo airport, buy thousands of Japanese yen to use during their stay in Japan. Assuming that no other changes are taking place with the yen, explain what effect these visitors' actions will have on the supply and demand of the U.S. dollar, on the supply and demand of the yen, and on the price of each currency.

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