

Economic Concepts

Demand and Supply

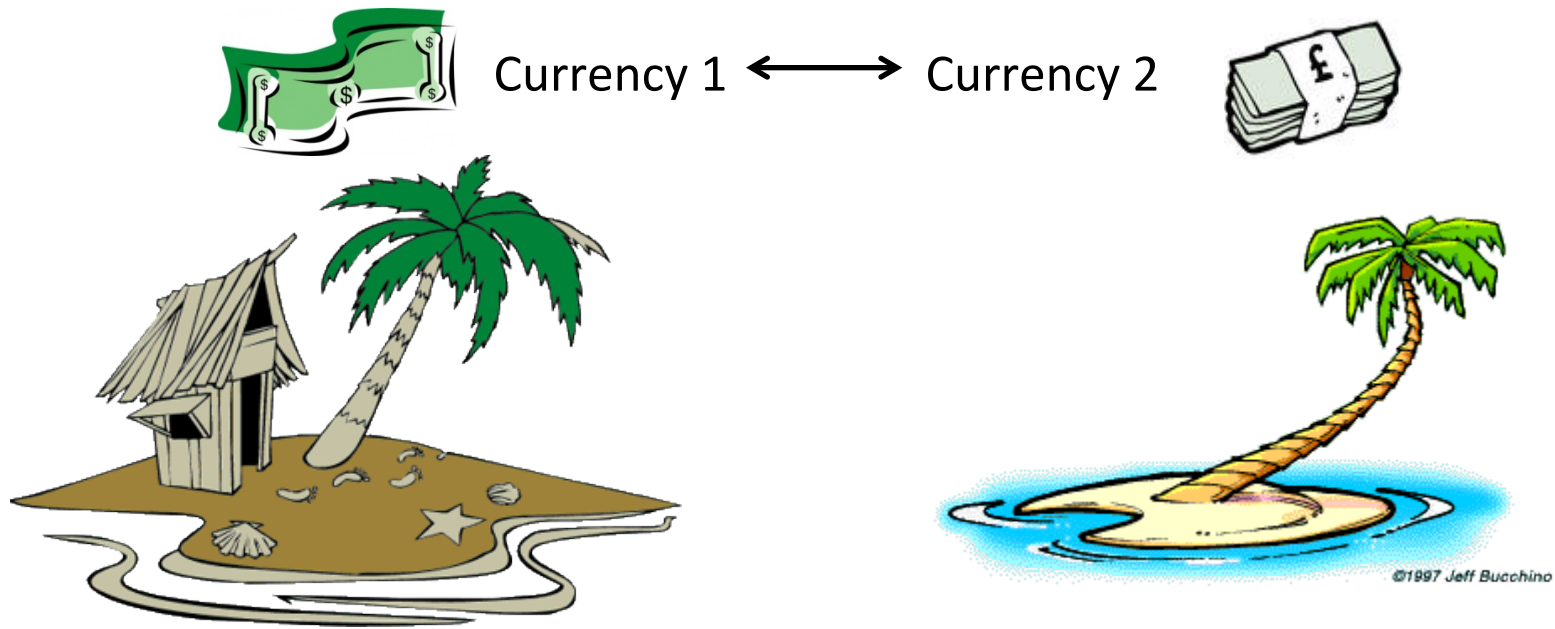
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Outline

- □ Demand Curve
 - Downward Sloping Curve
 - Change in Curve
- Supply Curve
 - Upward Sloping Curve
 - Change in Curve
- Currency Valuation
 - Equilibrium
 - Under pricing/ Overpricing

Currency Exchange



Why do people exchange currency?

Currency Exchange

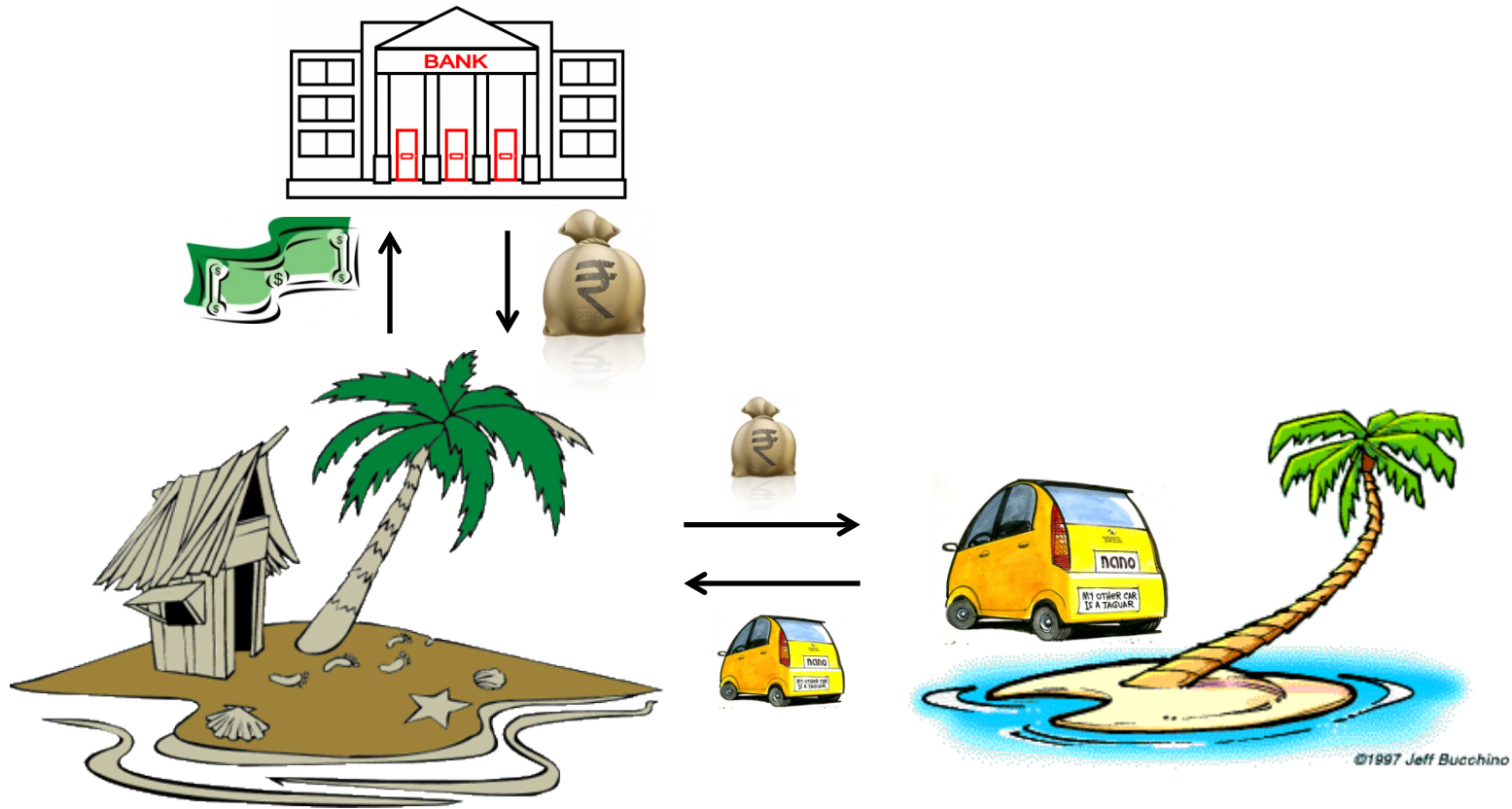


I have heard that there is a very cheap and efficient car being produced in some part of the world. What should I do to purchase it?

Oh Tata Nano!
You first need to buy some Indian Rupees for that.



Currency Exchange



United States

India



The Demand for a Currency

- The demand for a currency is a derived demand.
- It is derived from the demand for the goods and services denominated in that currency.
- For example, if the foreign demand for Indian goods and services increases, the demand for the Indian Rupee increases.

Downward Sloping Demand Curve

- If the Rupee depreciates, Indian goods, services, and financial assets become less expensive to foreign residents.



How come when the steel prices are increasing, TATA Nano is requiring less dollars to buy?

Price of Nano is increasing in the domestic market. It is actually the Rupee which is getting cheaper.



Downward Sloping Demand Curve

- Foreign residents will increase their quantity demanded of the Rupee to purchase more Indian goods, services, and financial assets.



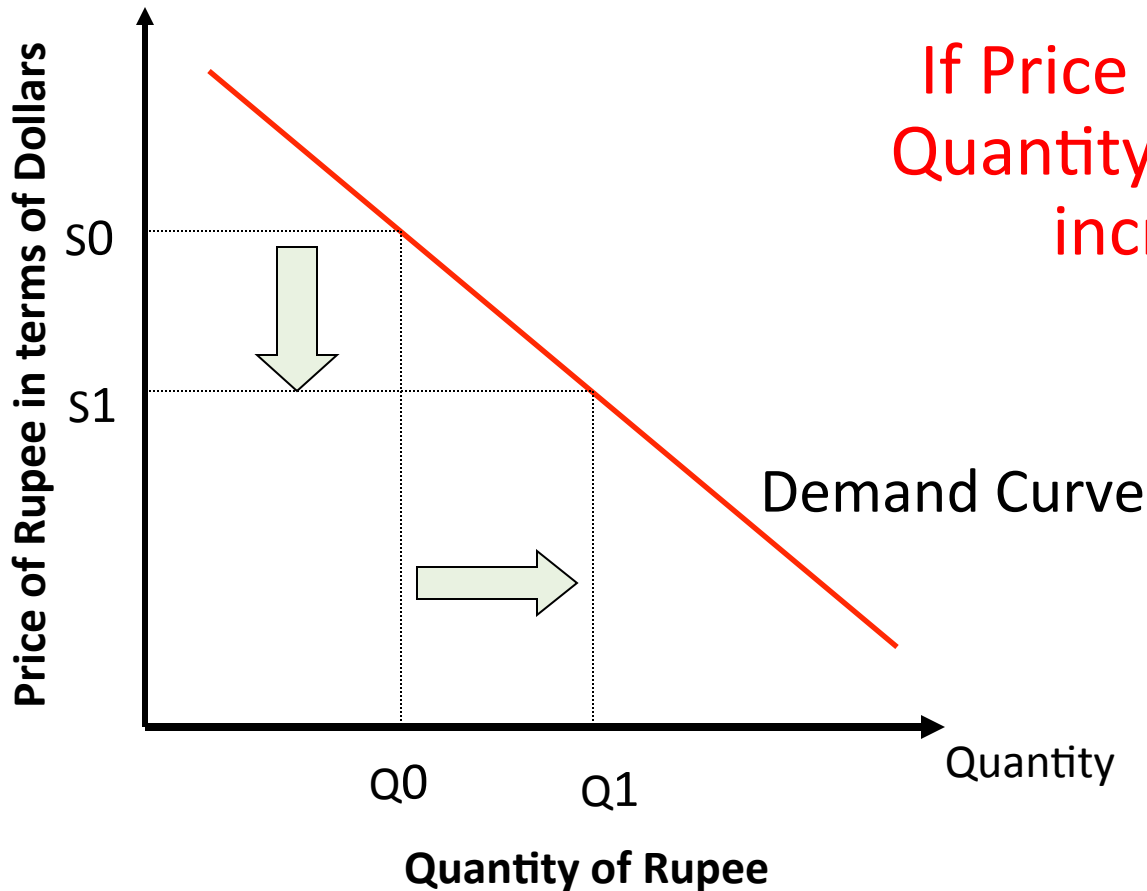
Hurray! Then I am going to buy more Nano's for my staff!

That would help in increasing the demand of Rupee Madam! Rupee may regain its lost value



The Demand Curve

S (\$)



If Price decreases,
Quantity demanded
increases.

Change in Demand Curve

- For years Olive Oil had a fixed Demand Curve.
- When Price \uparrow Demand \downarrow , Price \downarrow Demand \uparrow , otherwise it was constant.



- Recently it was discovered that Olive Oil has some great medicinal benefits like it is a rich source of Omega 3 Fatty Acids.
- Without changing the price, demand has increased by 30%.
- This exhibits shifting of the Demand Curve and happens when Economic Fundamentals change.

Change in Demand Curve

- In last 5 years, Demand Curve of Rupee has shifted leftward.



People have stopped investing in India due to the bureaucratic hurdles. As a result quantity of Rupee demanded has decreased.

- If for $1\text{USD} = 55\text{ INR}$, there was demand of 5 billion Rupee.
- Now for the same price there is only a demand of 3 billion Rupees.

Currency Exchange

We invite you to invest India! Now even Rupee is so cheap compared to Dollar!

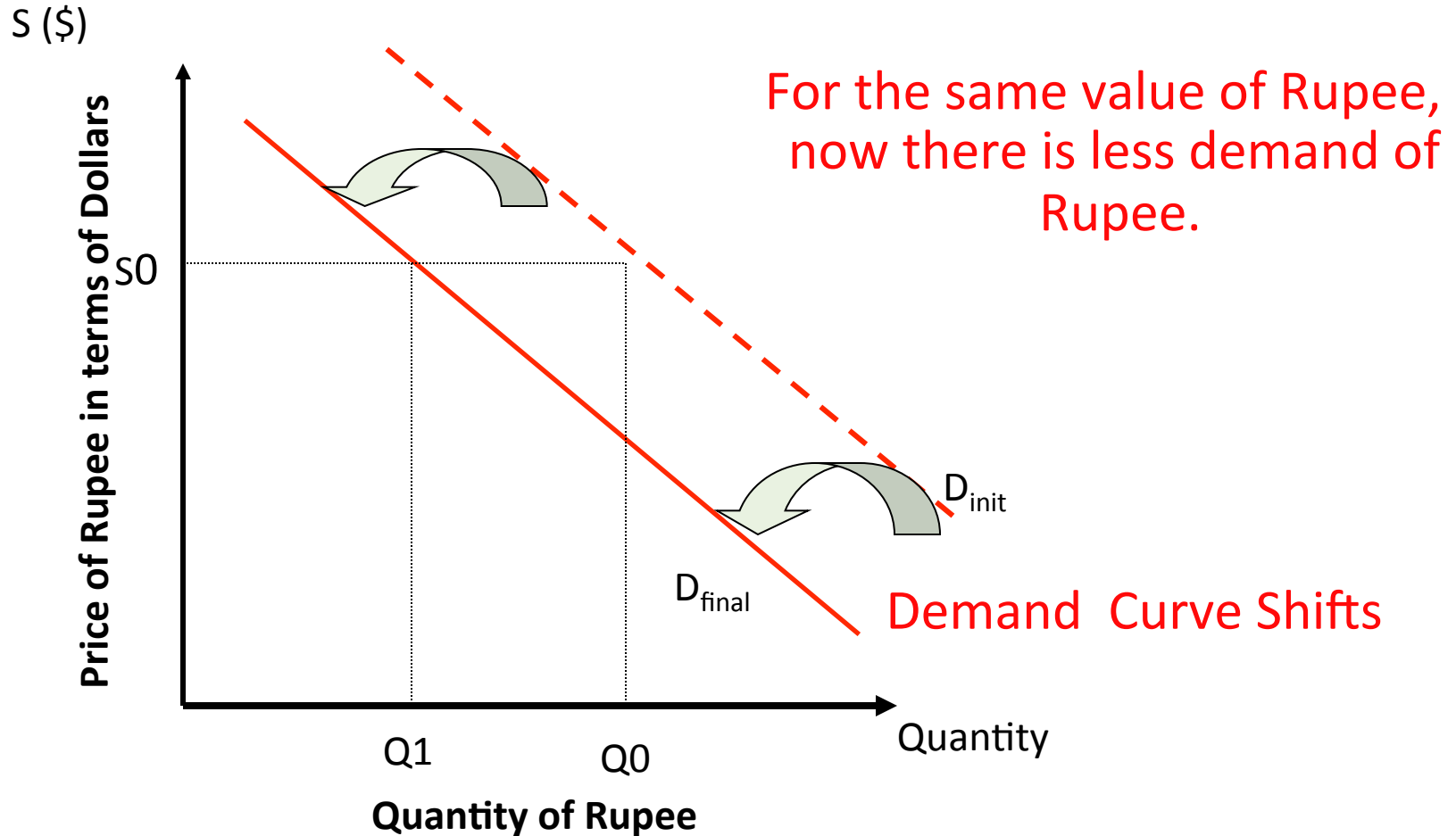


Surely we would! Just waiting for you to first exit ;)



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Change in Demand Curve





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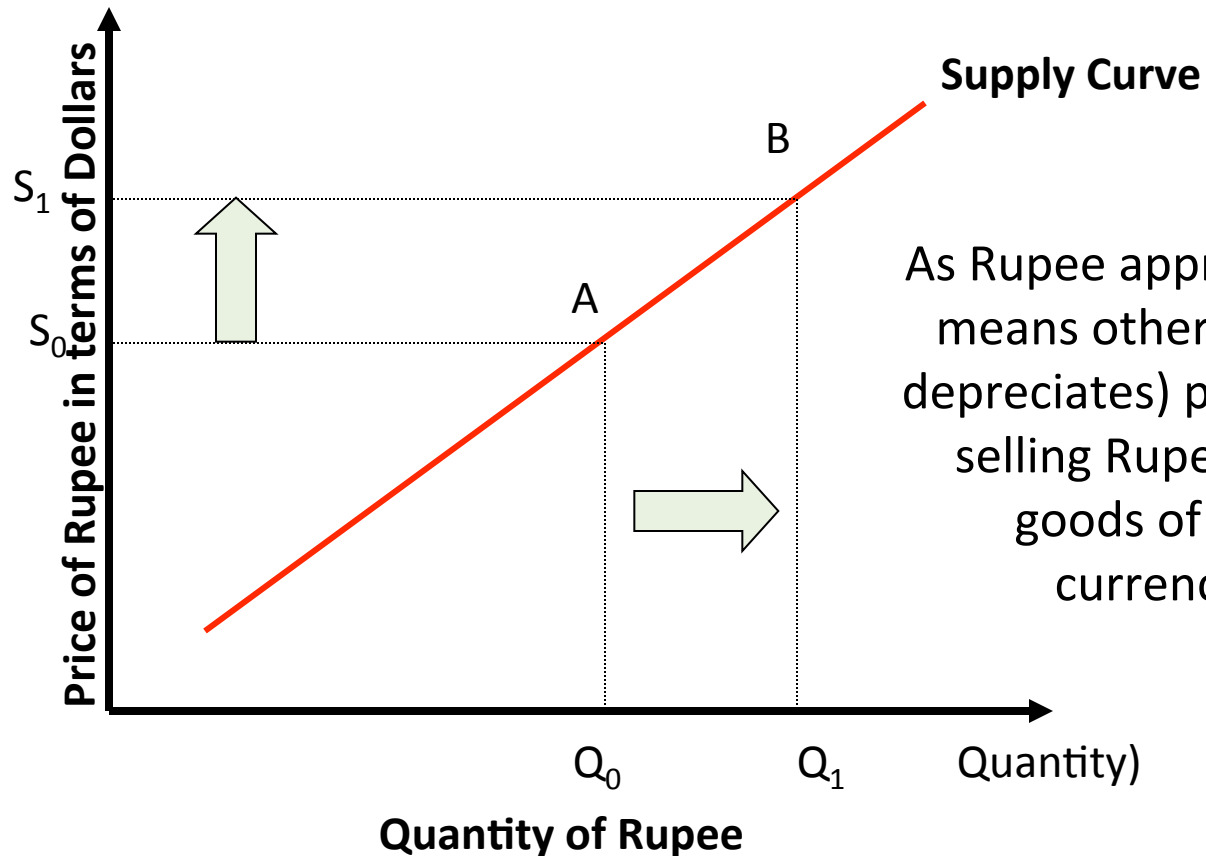


The Supply of a Currency

- The Supply of a currency is also derived.
- If an Indian wants to buy dollars, he would do using his Rupees. So he sells Rupee and buys Dollar.
- As more dollars are purchased, the quantity of Rupees supplied in the foreign exchange market increases.

The Supply of a Currency

$S (\$)$



As Rupee appreciates, (it means other currency depreciates) people start selling Rupee to buy goods of other currencies.

Change in Supply Curve

Only way I can bring US out of recession is by printing more dollars.

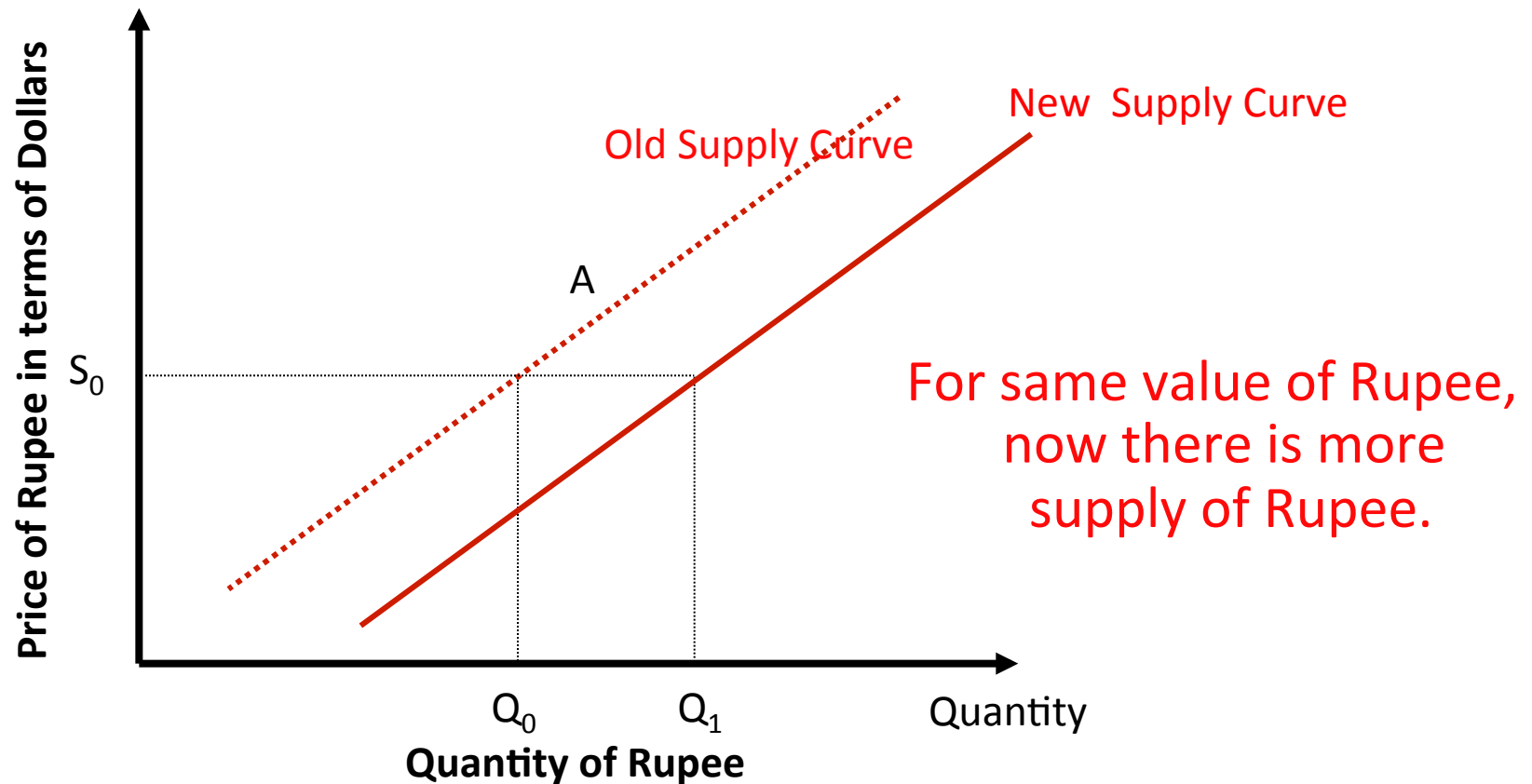


Thanks for Quantitative Easing!



Effect of Supply Shift

S (\$)





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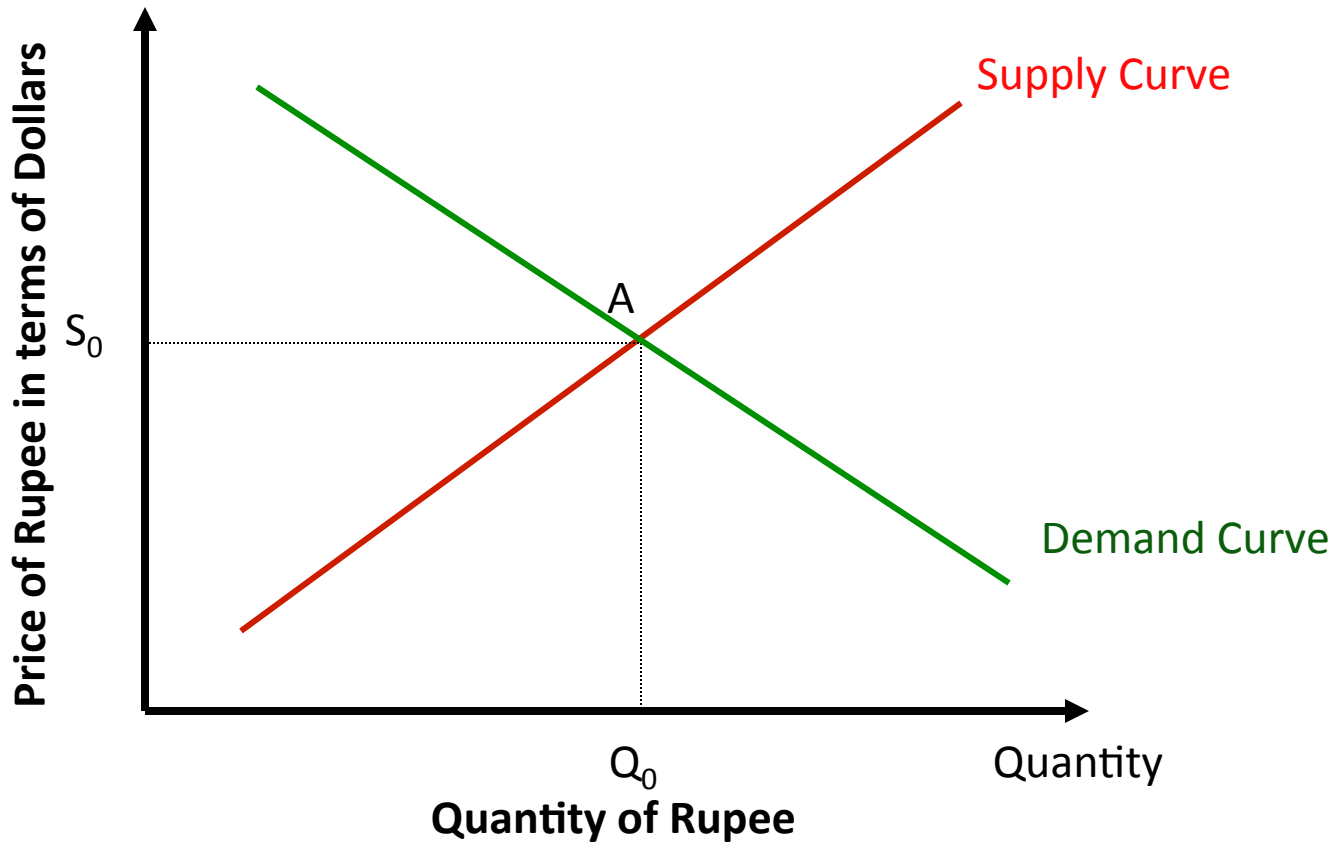


Equilibrium

- The market is in equilibrium when the quantity supplied of a currency is equal to the quantity demanded.
- This is the market clearing exchange rate.
- There is no surplus or shortage of the currency.

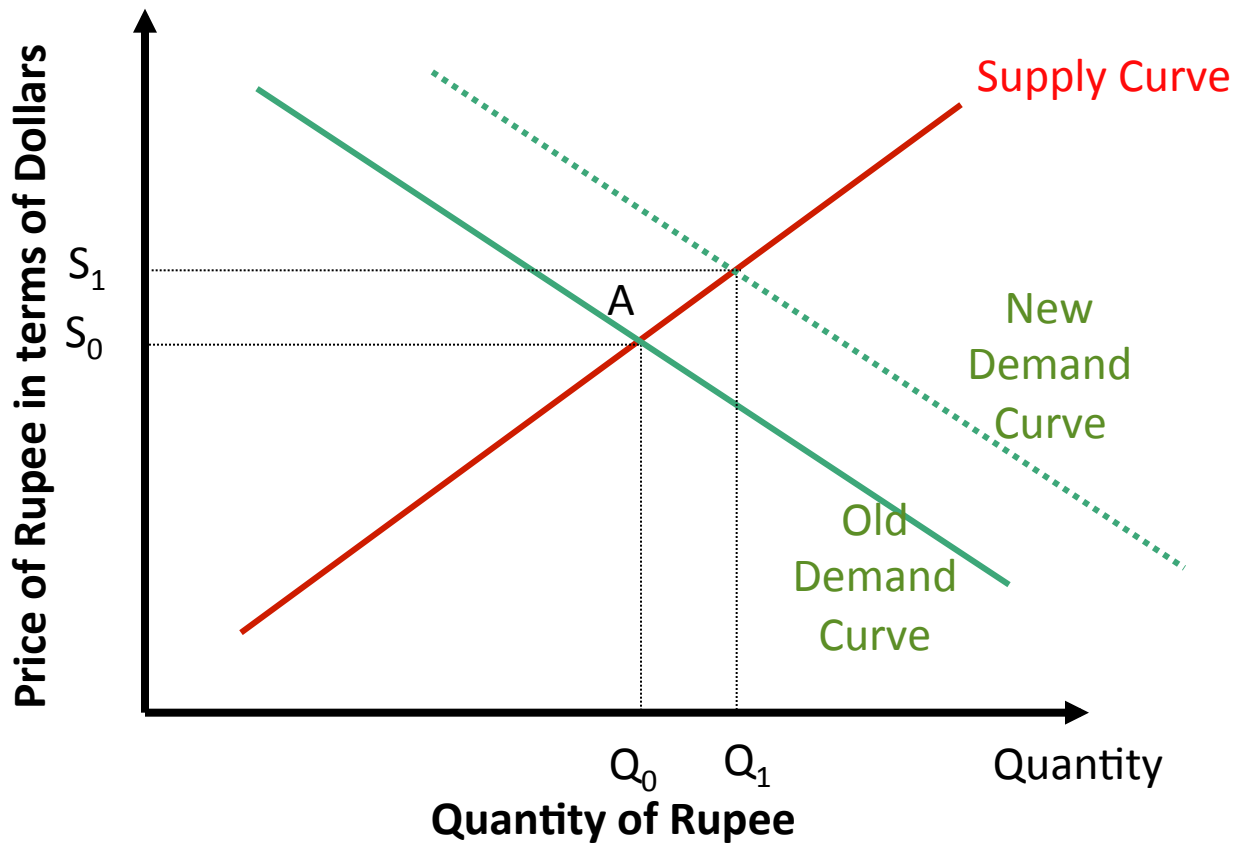
Equilibrium

$S (\$)$



Effect of Demand Shift

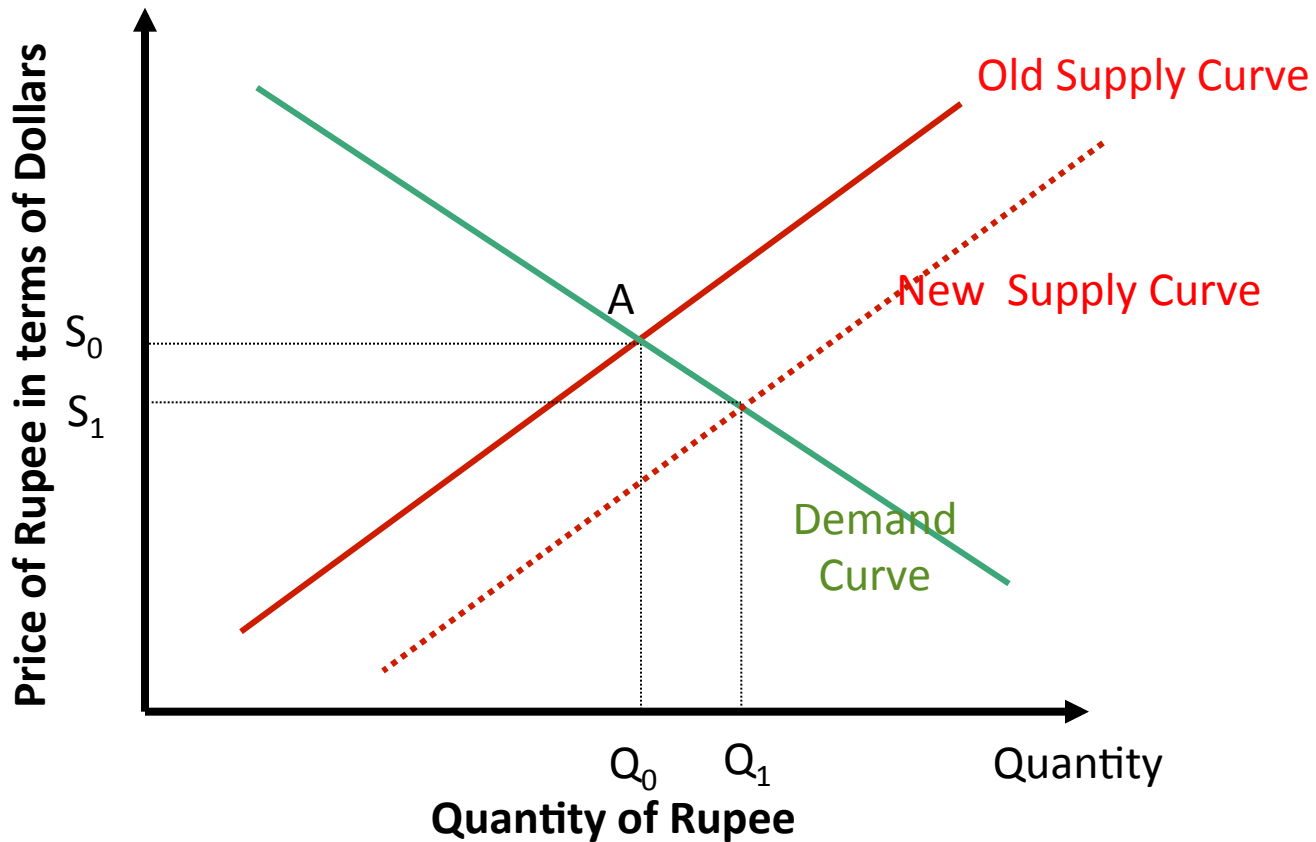
S (\$)



Demand increases, Price increases

Effect of Supply Shift

S (\$)



Supply increases, Price decreases



Over and Under-Valued Currencies

- If a currency's value is market determined, how can it be over- or under-valued?
- A currency is said to be over- or under-valued if the market exchange rate is different from the rate that a model or individual predicts to be the “correct” rate.
- In other words, the individual believes the market “has it wrong.”