

**Exchange Rates and the Foreign Exchange Market : Asset Approach**

**The Demand of Currency Deposits**

The annual return for ₱100 savings deposit with an interest rate of 2% is

- **Real rate of return:** inflation-adjusted rate of return, which represents the additional amount of goods & services that can be purchased with earnings from the asset.

The real rate of return for the above savings deposit when inflation is 1.5%

- After accounting for the rise in the prices of goods and services, the asset can purchase 0.5% more goods and services after 1 year.

If prices are fixed,

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Because trading of deposits in different currencies occurs on a daily basis,

But we assume that risk and liquidity of currency deposits in foreign exchange markets are essentially the same, regardless of their currency denomination.

We therefore say that investors are primarily concerned about the rates of return on currency deposits.

**Rates of return** that investors expect to earn are determined by

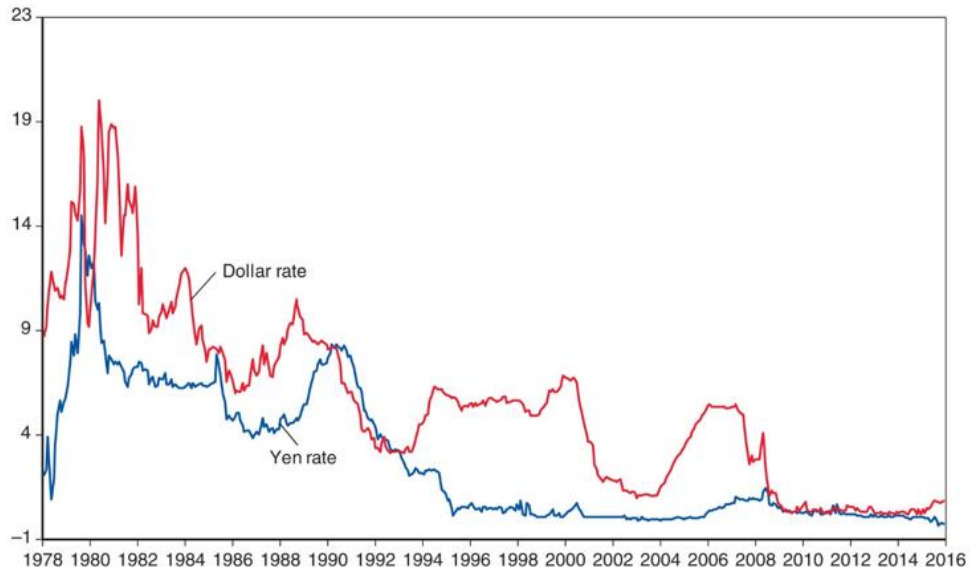
**Domestic currency**

The rate of return for a deposit in domestic currency is

**Foreign currency**

To compare the rate of return on a deposit in domestic currency with one in foreign currency, consider

Figure 14.2 Interest Rates on Dollar and Yen Deposits, 1978–2016



Since dollar and yen interest rates are not measured in comparable terms, they can move quite differently over time.

**Source: Datastream.** Three-month interest rates are shown.

**For example**

Suppose the interest rate on a baht deposit is 2% and the interest rate on a dollar deposit is 3%.

Let's compare this rate of return with the rate of return from a baht deposit.

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- We can simplify the analysis by saying that the baht rate of return on dollar deposits approximately equals
  - the interest rate on dollar deposits
  - plus the expected rate of depreciation of baht deposits

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**Graph : Exchange rate and expected baht return on dollar deposit**