PubPol/Econ 541

Class 5

Exchange Rates

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2024

Pause for News

News

- Trump on currency use:
  - "Many countries are leaving the dollar. You're not going to leave the dollar with me. I'll say, 'You leave the dollar, you're not doing business with the United States, because we're going to put 100 percent tariff on your goods, sir. We would like very much to get back to the dollar immediately. Thank you very much.' It's so easy."
  - Quoted in NYT by Krugman from Sep 7 Trump rally.

Quiz 2

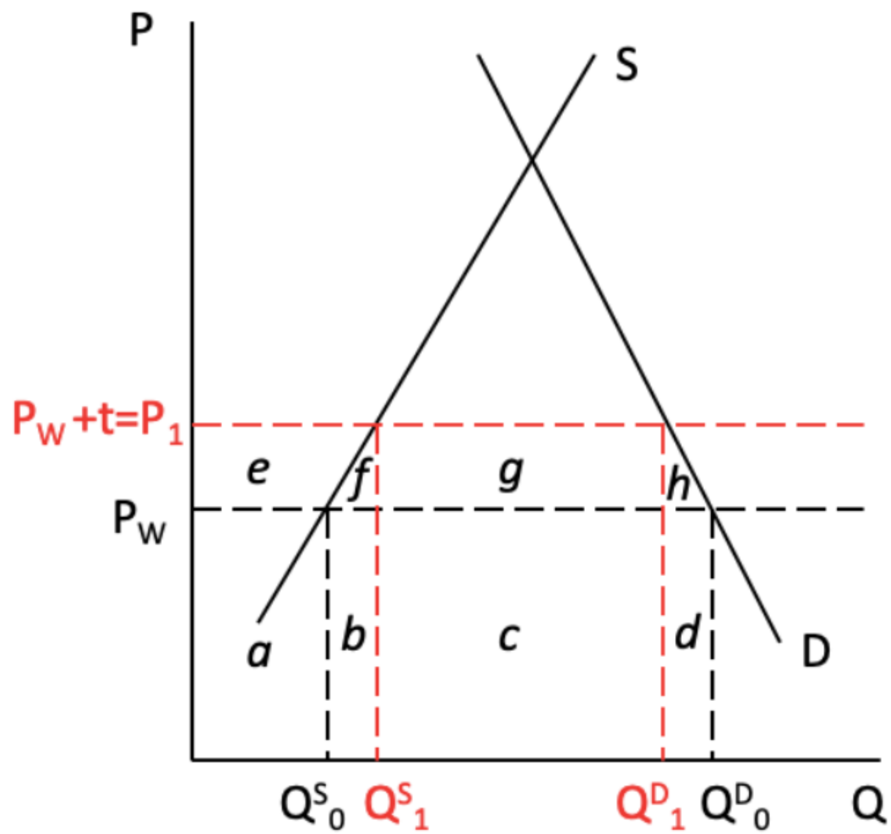
- Quiz results:

Mean	7.66	7.83
Median	7.5	8
Max	10	9
Min	5	6
Standard deviation	1.37	0.85

Quiz 2

Question 9:

- Suppliers' revenue = price times quantity, PQ.
- Change due to tariff is *e*+*f*+*b*
- Almost all answered just *e*, which is the change in producer surplus, or profit, not revenue.



Outline

- Exchange markets: What they are
- Supply and Demand
- Two Simple Theories
- Pegged Exchange Rates

Exchange Market

- Exchange rate is
  - – Price of one currency in terms of another
    - E.g., \$/£ or £/\$

Representative Exchange Rates for Selected Currencies

Last update: August 19, 2024, 14:08:11 ET

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TSV -- TSV tips

Exchange Rate Archives

Representative Exchange Rates		
Currency	**Note**	**Value as of August 19, 2024**
Chinese yuan		7.14080000
Euro	(1)	1.10410000
Japanese yen		147.86000000
U.K. pound	(1)	1.29495000
U.S. dollar		1.00000000

Notes:

These representative exchange rates, which are reported to the Fund by the issuing central bank, are expressed in terms of currency units per U.S. dollar, except for those indicated by

(1) which are in terms of U.S. dollars per currency unit.

Pause for Discussion

Questions on KOM, Ch 14

- Is an exchange rate the price of one country's goods in terms of another's, or the price of one country's assets in terms of another's?
- On what transactions are reported rates based?
- What hours of the day are the exchange markets open?

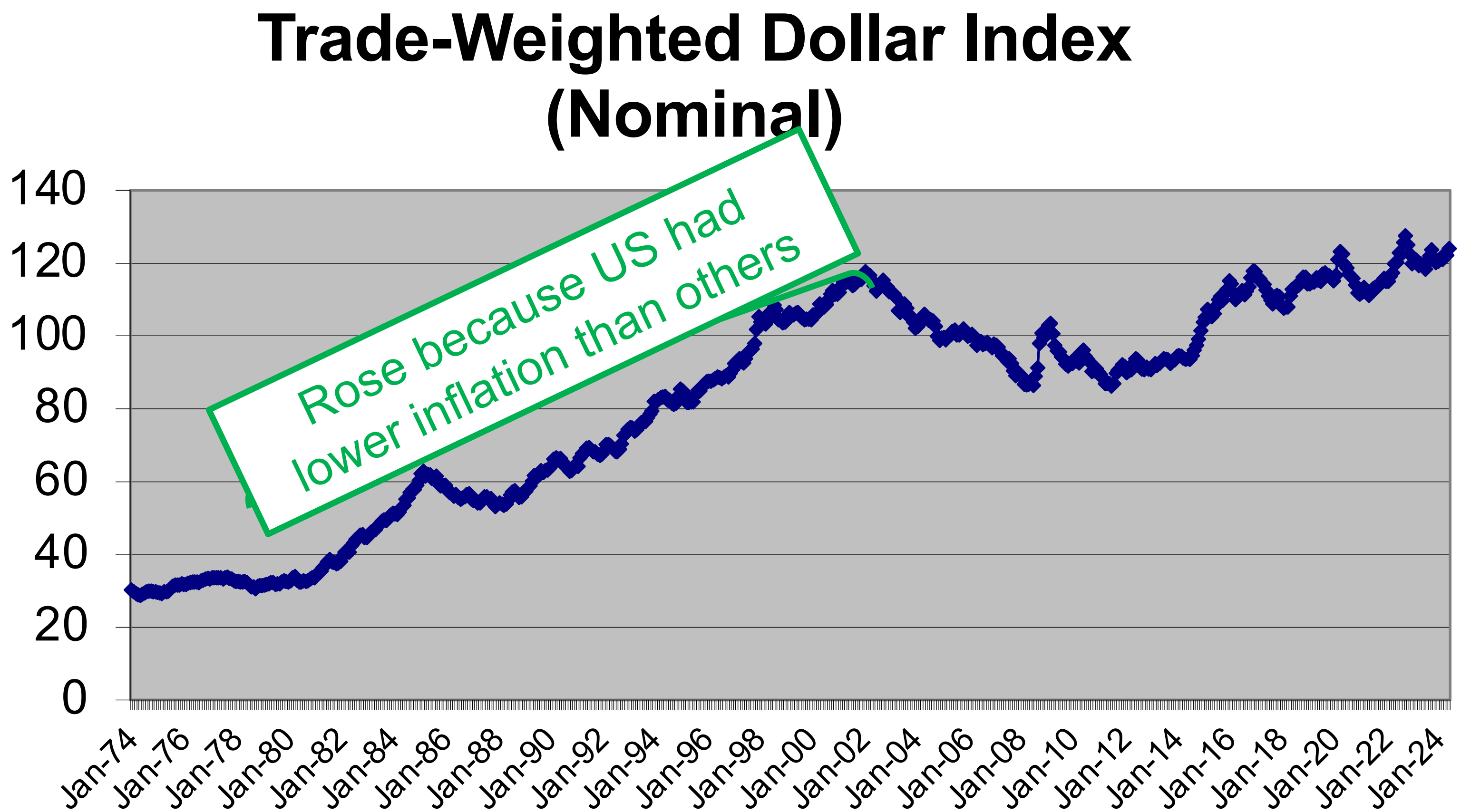
Exchange Market

- Types of exchange rate
  - Spot
    - For exchange of currencies today
  - Forward
    - Contracts for exchange of currencies 30, 60, 90 etc. days from the present
    - Both payment and receipt happen then, <u>not</u> now
  - Futures –
    - Like forward market, but for specific calendar dates in future

Exchange Market

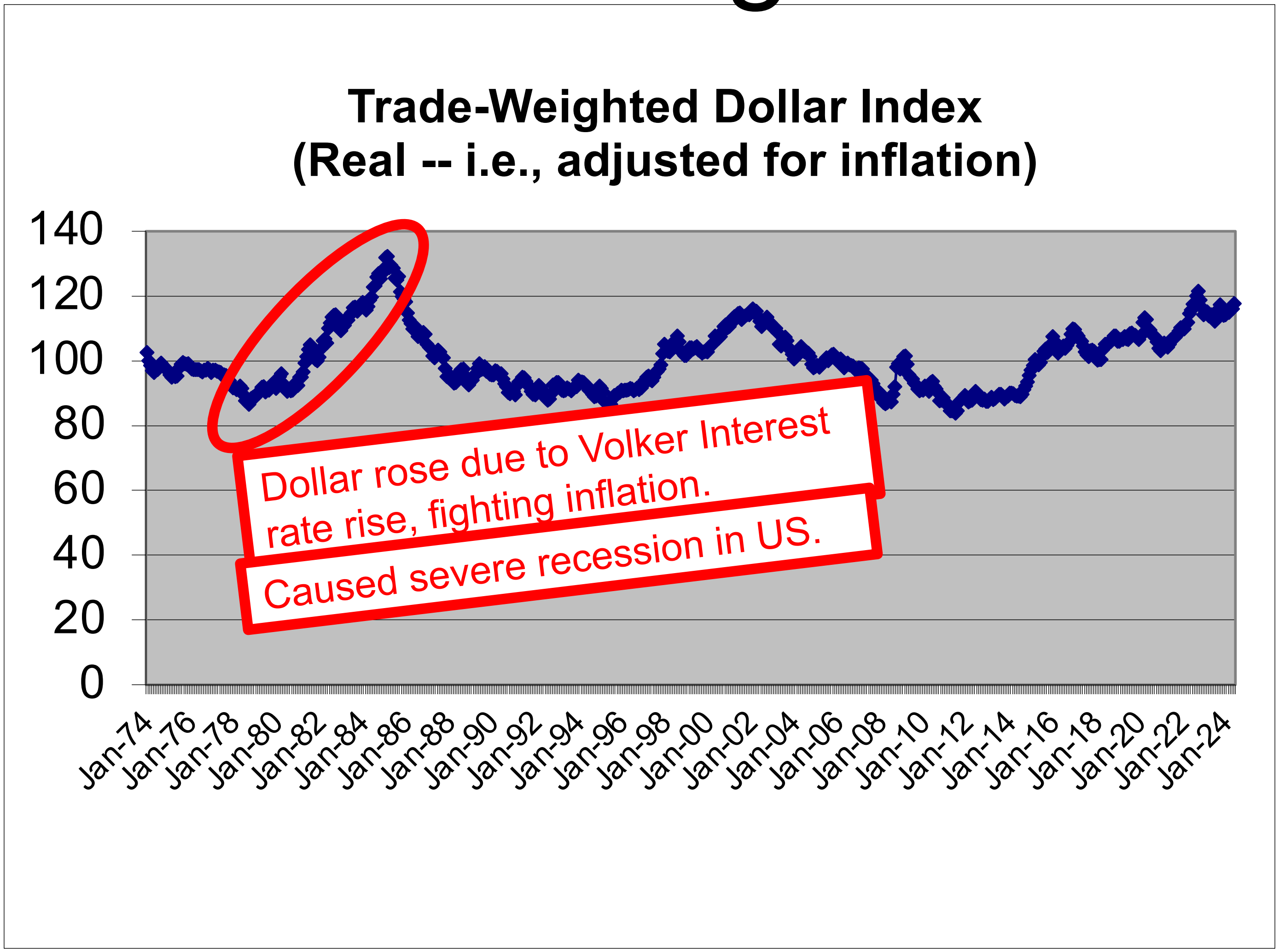
- Types of exchange rate, continued
  - Bilateral
    - For exchange of 2 currencies
  - Trade weighted
    - For one currency relative to multiple others
    - An average, or index
  - Real
    - Adjusted for inflation, both at home and abroad

Exchange Rate



Source: Federal Reserve

Exchange Rate



Source: Federal Reserve

Exchange Market

- Who uses the exchange market
  - Traders in both goods and services
    - Also travelers (but that's trade)
  - International borrowing, lending, and asset trade
  - Speculators
    - Buyers or sellers who hope to profit from future exchange-rate change
  - Hedgers
  - Arbitragers

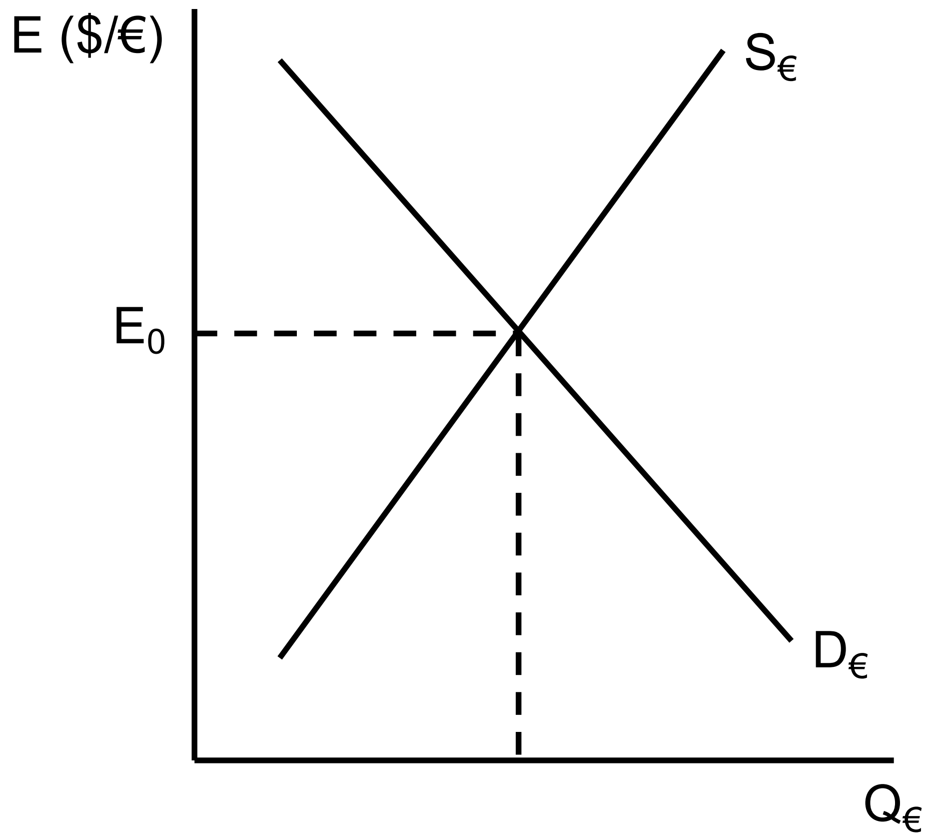
Pause for Discussion

More Questions from KOM

- What is “arbitrage” in the foreign exchange market?
- What is “hedging” in the foreign exchange market?
- What role does the US dollar play in international finance?

Supply and Demand for Foreign Exchange

- Market Model:



Questions:

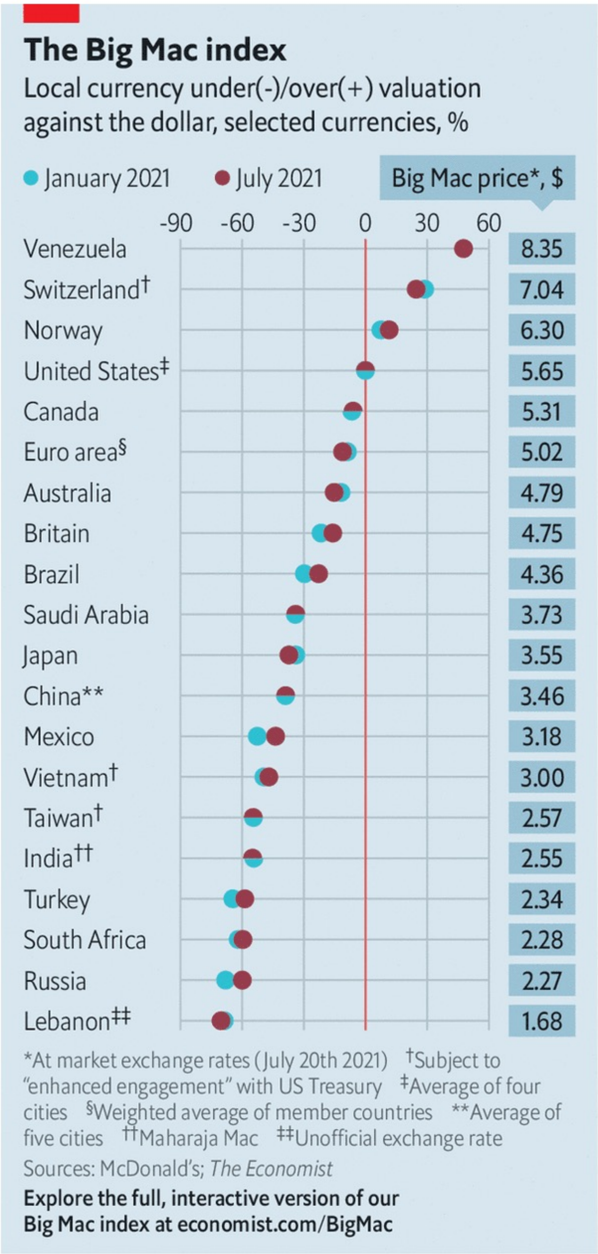
- Who demands €?
- Who supplies €?

Exchange Market

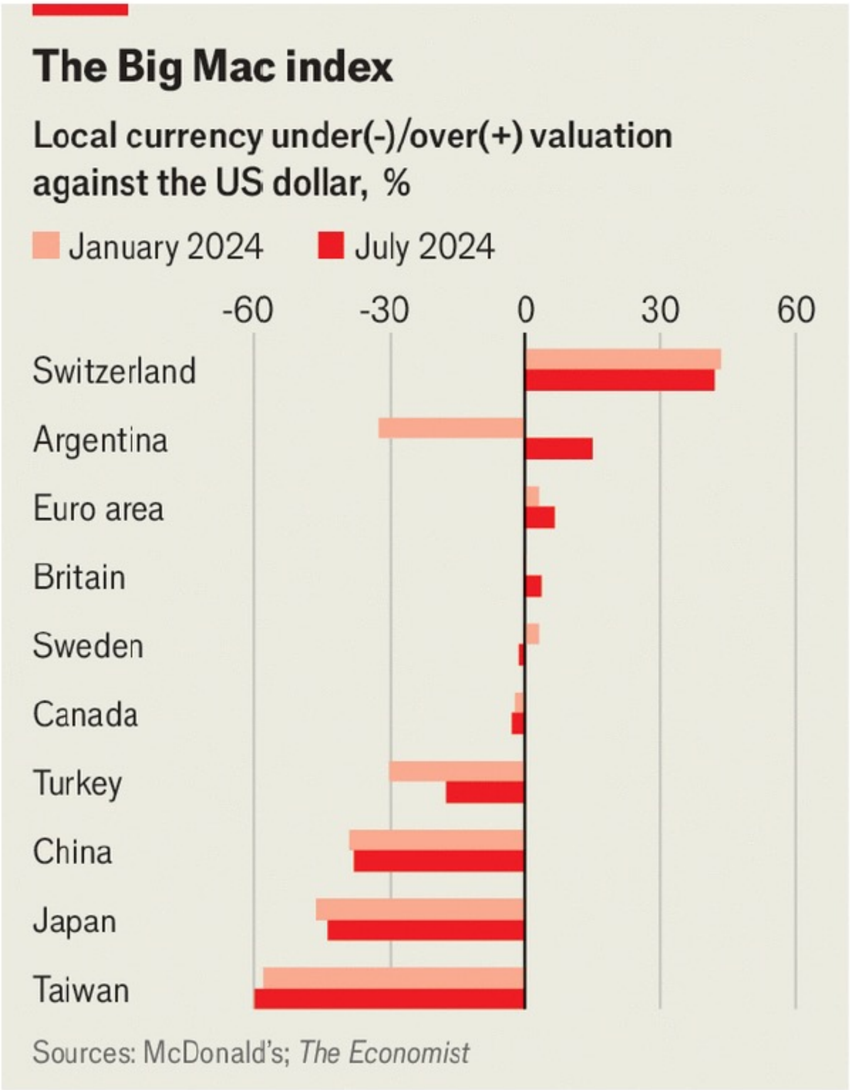
- Traders respond to
  - Prices of goods
    - Rise in home prices causes currency to fall
- Capital movements respond to
  - Interest rates
    - Rise in home interest rate causes currency to rise
  - Expectations
    - Expectation of any change causes that change

Two Simple Theories

- Asset Theory
  - Simple: E is whatever it is expected to be
    - If it were not, its expected change would drive capital flows that would swamp the market
  - Works best in short run (but not useful)
- PPP = Purchasing Power Parity
  - Exchange rate reflects the prices of goods
  - See Big Mac Index
  - Works best in long run



From July 2021



From August 2024

Pause for Discussion

Questions on Economist, “Big Mac index”

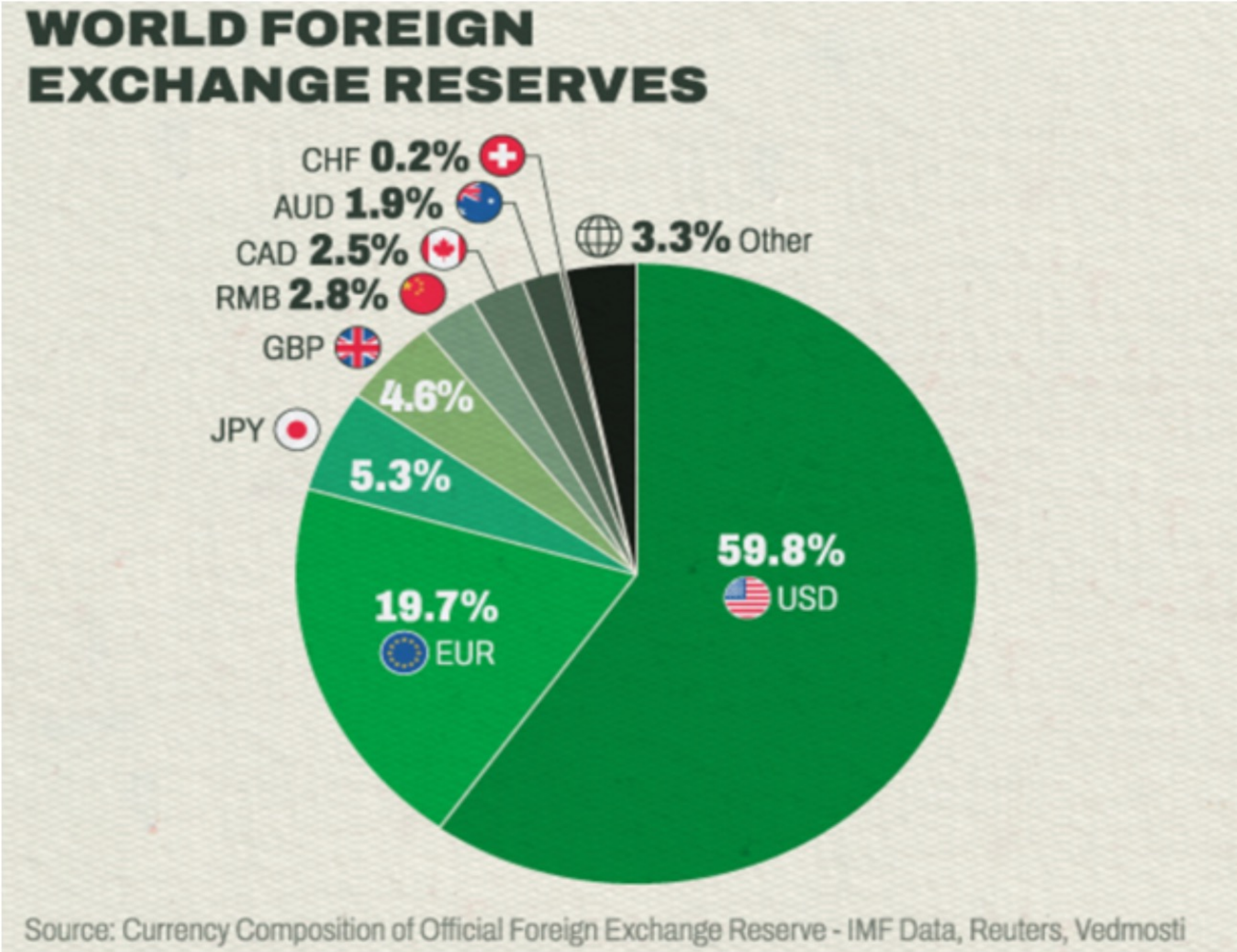
- On what basis does this article rank countries?
- Why does this article focus on the Vietnamese currency, the dong?
- What criteria does the US Treasury use to identify an undervalued currency?
- Is Vietnam’s poverty relevant to this?

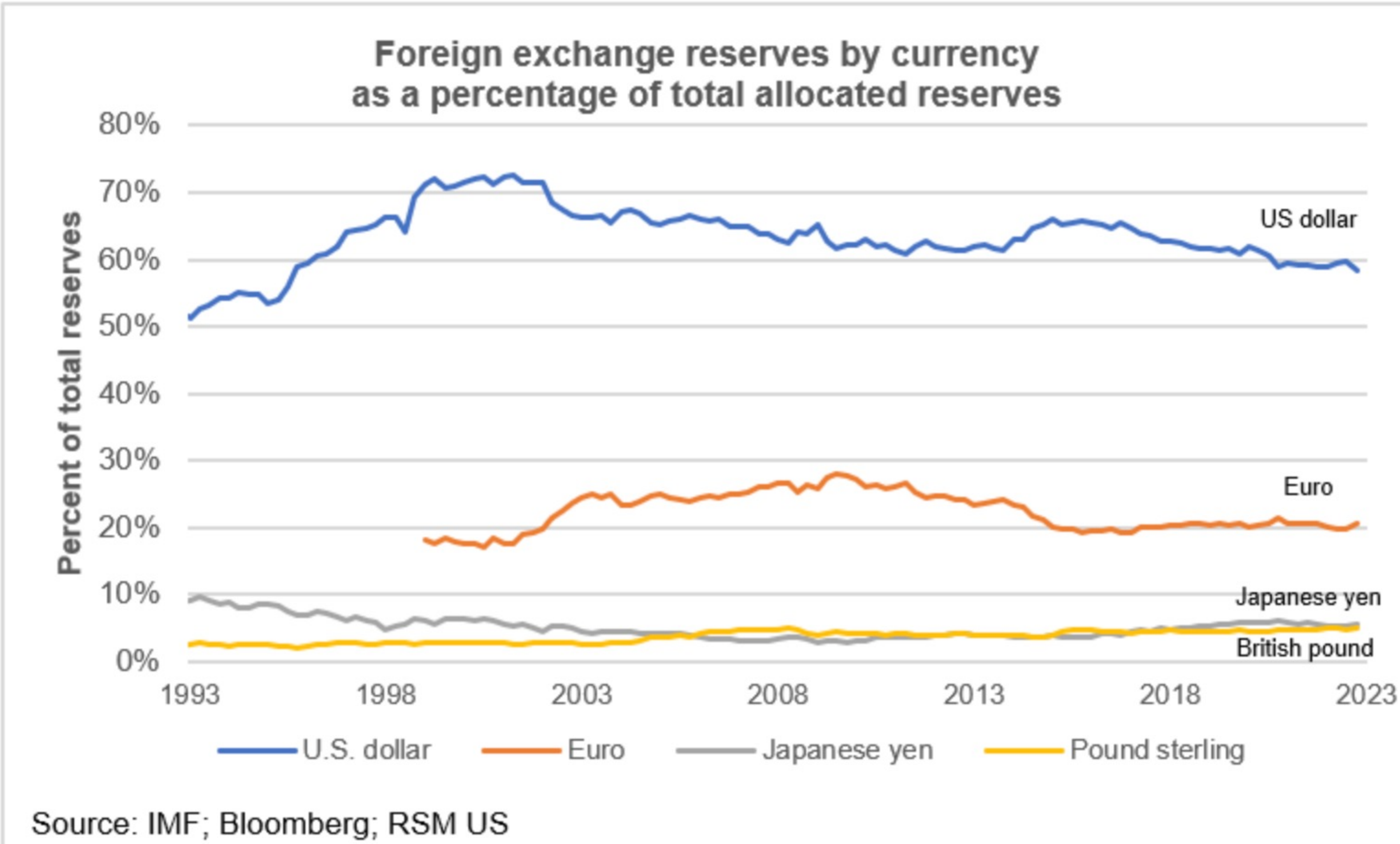
Questions on Economist, “Burgernomics”

- Why is the Big Mac hamburger a good choice to measuring PPP, if one needs to do it with only a single good?
- What currencies are most under- and over-valued among those reported here?
- Why has Argentina’s position changed so much since January?
- Is this a good measure of PPP? What would be better, and why not use it?

Pegged Exchange Rates

- Bretton-Woods System
  - Successor to the Gold Standard
  - Most currencies pegged to US $
- How to peg
  - Need "reserves" of foreign currency
  - Use them to buy or sell own currency as needed
- Does it work? Yes and no


WORLD FOREIGN
EXCHANGE RESERVES
CHF 0.2%
AUD 1.9%
CAD 2.5%
RMB 2.8%
GBP
4.6%
JPY
5.3%
3.3% Other
59.8%
USD
19.7%
EUR
Source: Currency Composition of Official Foreign Exchange Reserve - IMF Data, Reuters, Vedmosti


Foreign exchange reserves by currency
as a percentage of total allocated reserves
Percent of total reserves
80%
70%
60%
50%
40%
30%
20%
10%
0%
1993
1998
2003
2008
2013
2018
2023
US dollar
Euro
Japanese yen
British pound
U.S. dollar
Euro
Japanese yen
Pound sterling
Source: IMF; Bloomberg; RSM US

Pause for Discussion

Questions on Economist, "…Bretton Woods…"

- What names and characteristics describe the three international monetary regimes that the *Economist* article describes, the last of which may be coming to an end?
- Why did the world not shift to using dollars, euros, and renminbi more equally for transactions and reserves?
- Why is currency stability so hard to achieve?

Questions on McDougall, "US Dollar to Maintain…"

- Why do central banks hold foreign-currency reserves?
- Has holding of US dollar reserves by central banks declined over time, and what is expected in the near and farther future?
- Who is mentioned as wanting reduced reliance on the dollar?
- What currency is most likely to expand being held?

Questions on Eichengreen, “The fate of dollar …”

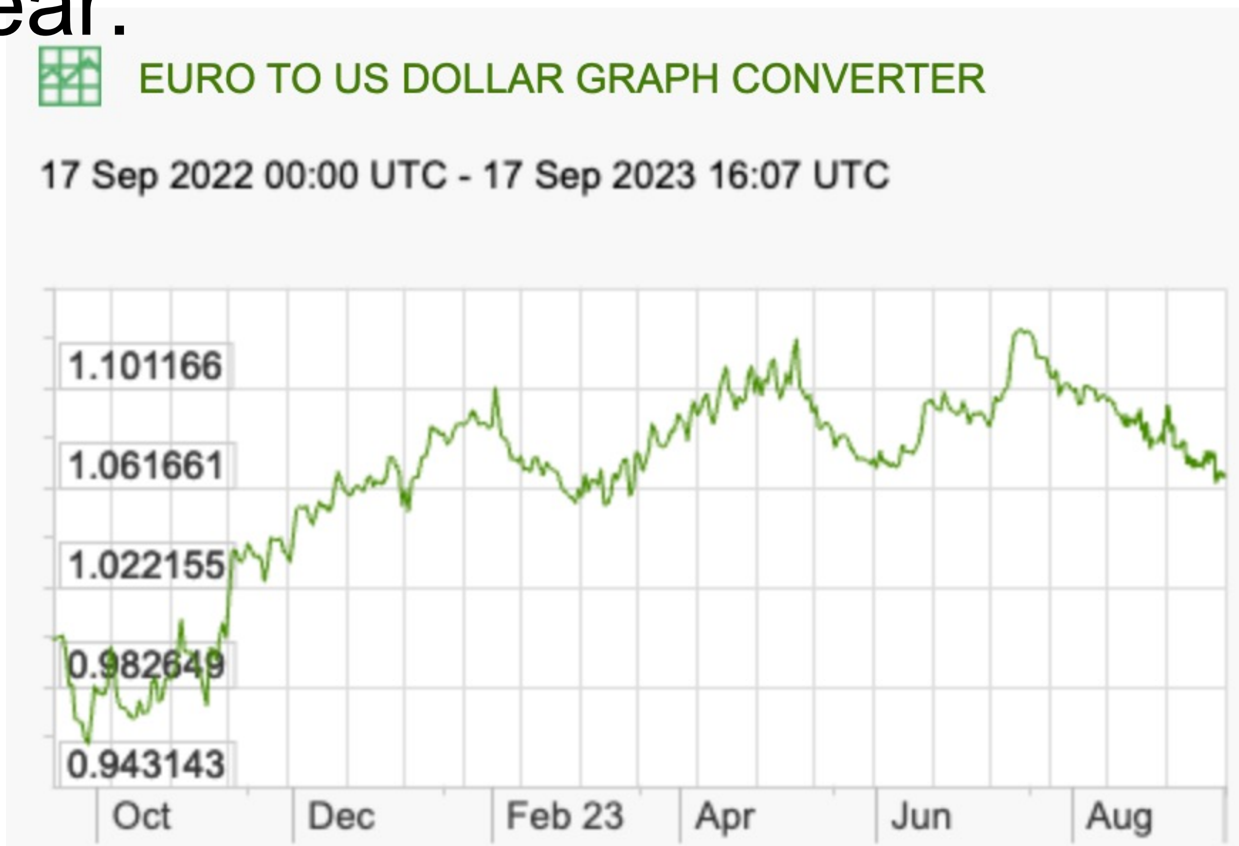
- How did Biden’s policies in his first term effect the dollar, and why?
- What does the author expect from a second Biden term?
- How did Trump’s election effect the dollar in 2016?
- Why might the dollar rise in a Trump second term?
- Why might the dollar fall in a Trump second term?

Some Recent Exchange Rate Movements

- Most from X-rates.com
- Most are US $ per country currency
- Showing
  - Major currencies last year and this
  - This year only for currencies of current students in the course
- If you have comments on yours, I'd welcome them

Recent Rate Movements: Euro

Last Year:



Source: X-rates.com

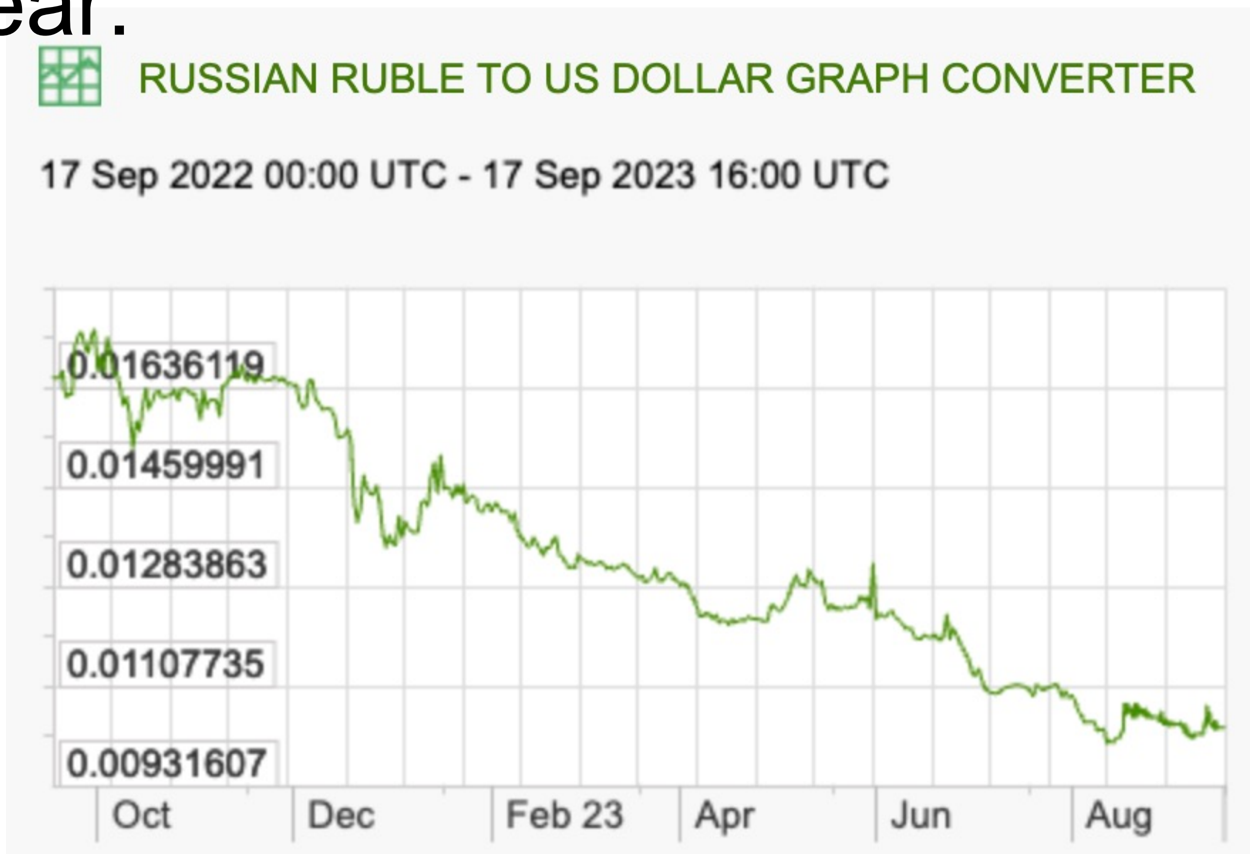
Recent Rate Movements: Euro

This Year:

Source: X-rates.com

Recent Rate Movements: Russia

Last Year:



Source: X-rates.com

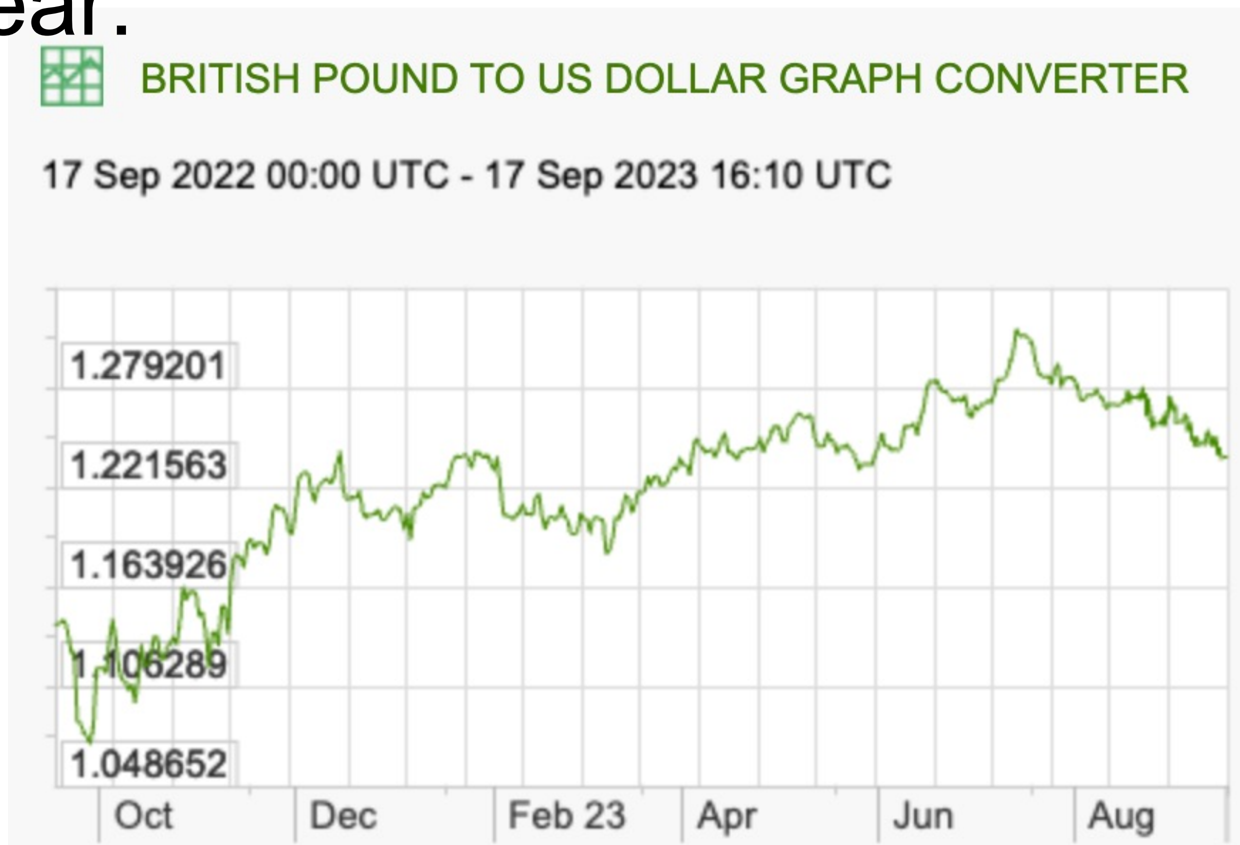
Recent Rate Movements: Russia

This Year:

Source: X-rates.com

Recent Rate Movements: UK

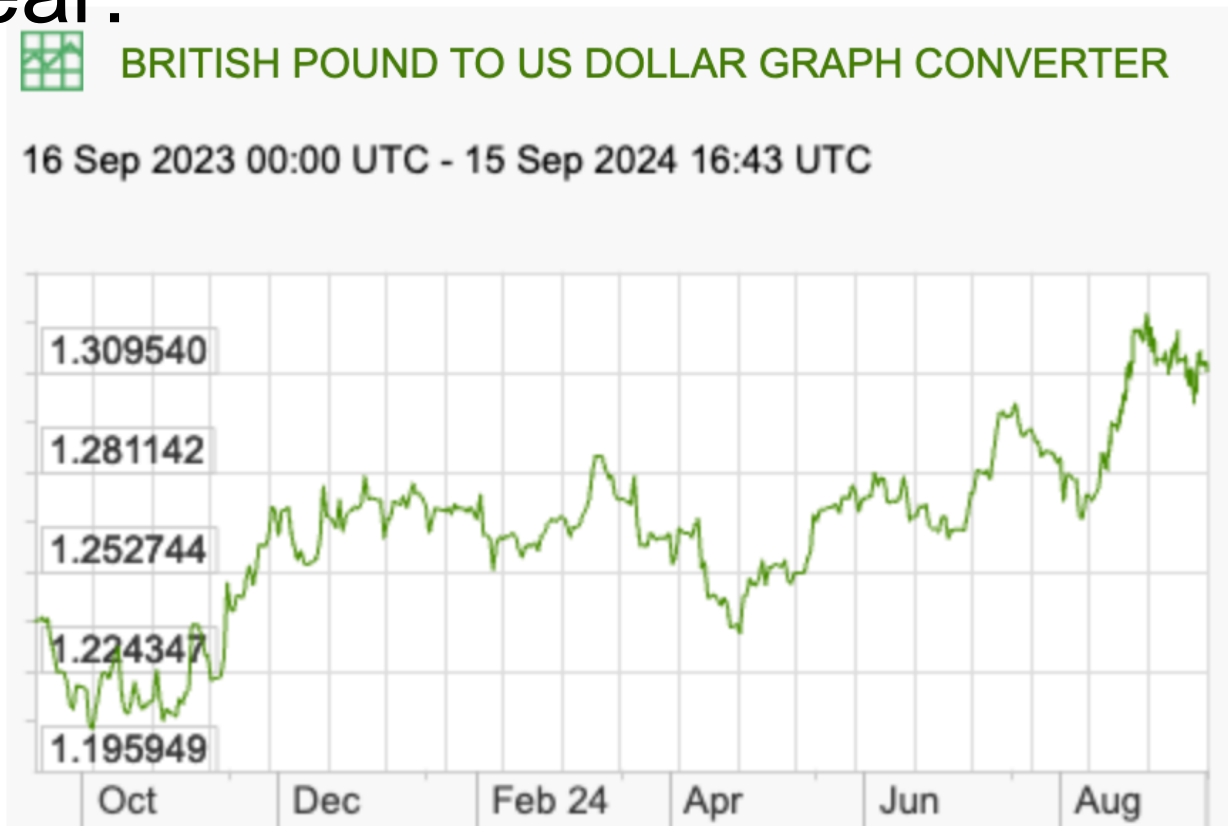
Last Year:



Source: X-rates.com

Recent Rate Movements: UK

This Year:



Source: X-rates.com

Recent Rate Movements: China

Last Year:

Source: X-rates.com

Recent Rate Movements: China

This Year:

Source: X-rates.com

Recent Rate Movements: Japan

Last Year:

Source: X-rates.com

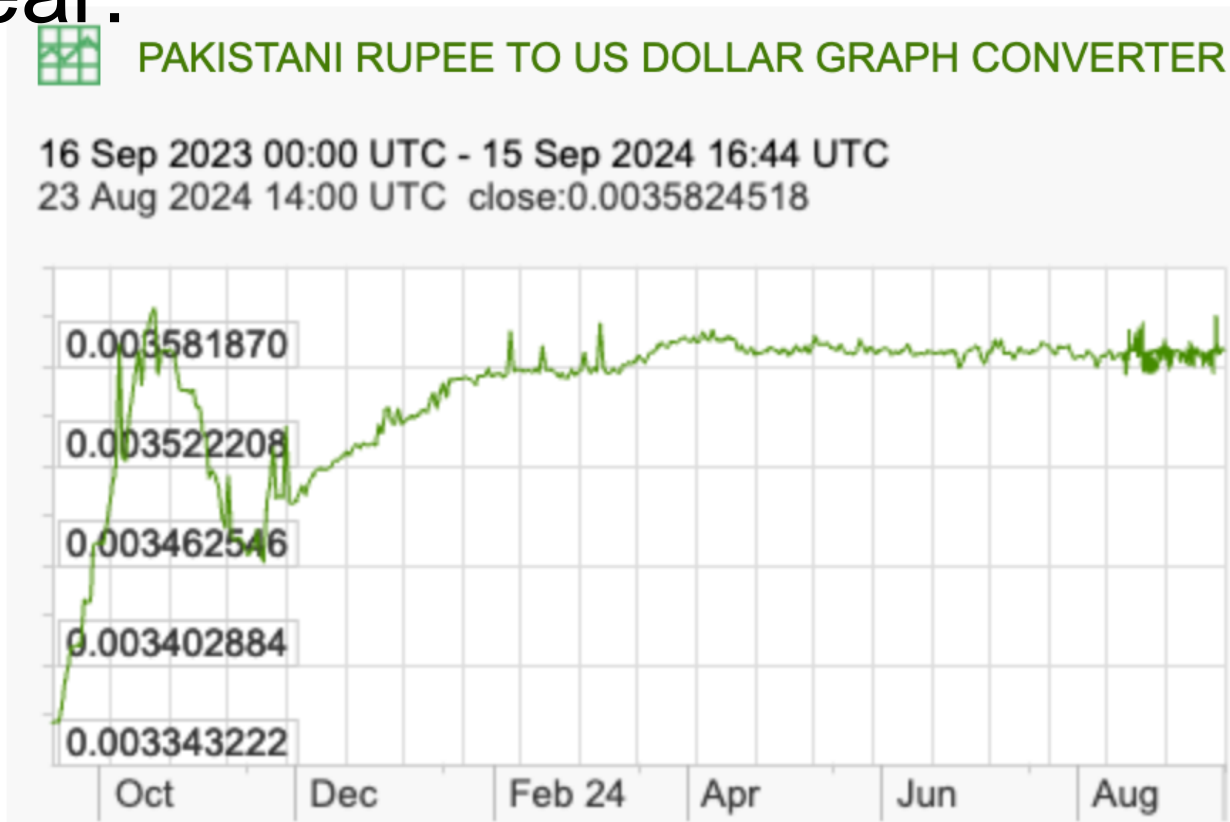
Recent Rate Movements: Japan

This Year:

Source: X-rates.com

Recent Rate Movements: Pakistan

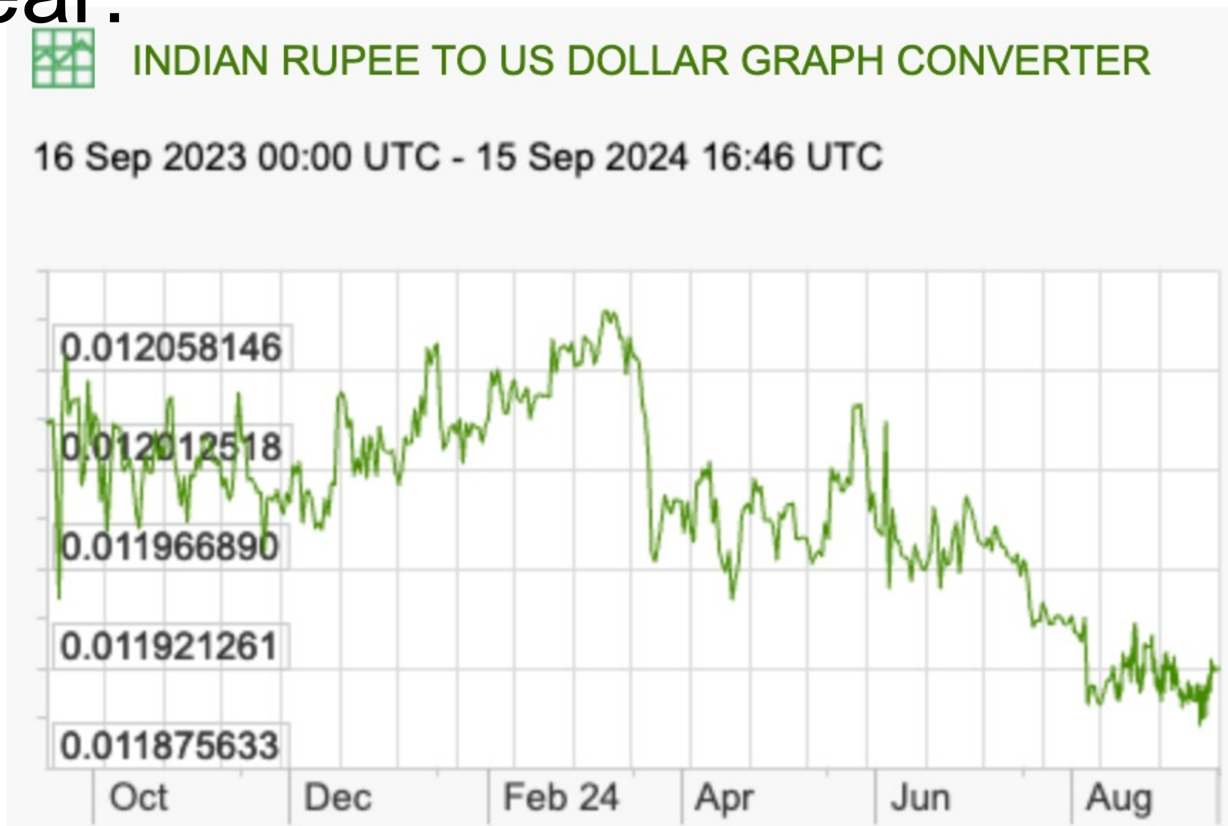
This Year:



Source: X-rates.com

Recent Rate Movements: India

This Year:



Source: X-rates.com

Recent Rate Movements: Taiwan

This Year:

Source: X-rates.com

Recent Rate Movements: Uzbekistan

This Year:

Note: This is Som/$, not $/Som

Source: Trading Economics