

Exchange Rates

KOM, Ch 14, pp. 350-360:

- 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? **<a: Neither, or both. That is, it is literally the price of one country's currency in terms of another, and not directly of either goods or assets. But in fact it also plays a major role in determining relative prices of both goods and assets, and therefore may be usefully interpreted as both.>**
- How important are foreign exchange transactions by individual consumers as part of the foreign exchange market? **<a: Not important at all. The text says they are an "insignificant fraction.">**
- How big must an exchange market transaction be in order to qualify for the exchange rates reported in the newspapers? **<a: Those rates apply to transactions among banks, so even a corporation probably cannot get rates quite that good. The book mentions that "No amount less than \$1 million is traded at those rates.>**
- What hours of the day are the exchange markets open? **<a: All hours, as the market exists in major cities all around the world.>**
- What is a vehicle currency, and what currency is most likely to play that role in today's world? How are exchanges of two non-vehicle currencies accomplished? **<a: A vehicle currency is one that most currency exchanges are done in terms of, and it is also used to denominate contracts by parties outside the country of that currency. The US dollar mainly plays that role. It means that if two other currencies are to be exchanged, each will likely be exchanged first for dollars and then for the other currency.>**
- In the context of the foreign exchange markets, what are examples of "arbitrage" and "hedging"? **<a: Arbitrage is the simultaneous purchase and sale of the same thing, such as a foreign currency, at two different prices in two different markets, such as New York and London, in order to make a profit from the price difference. Hedging is the use of a forward contract to lock in the price of foreign exchange for a future date at which one expects to need it for a transaction.>**

Economist, "The Big Mac index: What the Big Mac index says about the dollar and the dong," 2021

- On what basis does this article rank countries? **<a: The prices of their Big Mac hamburgers, converted to dollars at the going exchange rate.>**
- What exchange rate theory is this applying or testing, and what does it say? **<a: Purchasing Power Parity, which says that exchange rates should reflect what currencies can buy.>**

- Why does this article focus on the Vietnamese currency, the dong? **<a: Because the US Treasury is pressing Vietnam to stop undervaluing its currency, and a deal for that was recently reached.>**
- What criteria do the US Treasury use to identify an undervalued currency (“currency manipulation,” though that term is not mentioned here)? **<a: Significant trade surplus with US; material trade surplus with world; and central bank purchases of dollars.>**
- Is Vietnam’s poverty relevant to this? **<a: Yes, poor countries normally have cheaper currency by the PPP measure, though this article doesn’t say why.>**

Economist, “What comes after Bretton Woods II?” 2019.

- What names and characteristics describe the three international monetary regimes that this article describes, the last of which may be coming to an end? **<a: Gold standard, fixed rates tied to gold, ended with the turmoil of the 1930s; Bretton Woods, pegged rates tied to the US dollar, ended with Nixon’s exit in the early 1970s; and floating rates with dollar still central to trade and finance, with increasing reserves of dollar assets, perhaps ending now with anger over globalization and with Trump.>**
- Why did the world not shift to using dollars, euros, and renminbi more equally for transactions and reserves? **<a: The “turmoil of the last decade” [crises, including the eurozone?] and the weakening Chinese economy kept the dollar looking most safe.>**
- Why is currency stability so hard to achieve? **<a: Governments’ efforts to manage currencies are constrained by certain trade-offs. Pegging them to an external anchor to stabilise their value means either ceding control of domestic economic policy or restricting access to foreign capital flows.>**
- What are the two scenarios that the author sees may happen next? **<a: If Trump is not reelected, then a Democratic president might do an orderly depreciation of the dollar and at the same time commit to a rules-based international order. If Trump is reelected, then something more like the turmoil of the 1930s.>**

McDougall, Mary, "US Dollar to Maintain Dominance Over Next Decade, Say Central Banks," *Financial Times*, June 27, 2023.

- Why do central banks hold foreign-currency reserves? **<a: “for international payments and to support local currencies.”>**
- Has holding of US dollar reserves by central banks declined over time, and what is expected in the near and farther future? **<a: It has declined from over 70% in 2000 to 58% now. It is expected to decline to 54%, but not in the next two years, only in the next ten.>**
- Who is mentioned as wanting reduced reliance on the dollar? **<a: China, and the presidents of Brazil and South Africa.>**
- What currency is most likely to expand being held? **<a: The euro. China wants it to be the renminbi, but worries about China-US relations are said to discourage that.>**

Optional to Read:

Economist, "Patty-purchasing power: The dollar is now better value, says the Big Mac index," *the Economist*, August 3, 2023.

- How did Big Mac inflation (it's rise in price) compare in other countries reported here to the US? **<a: It rose faster in all but China.>**
- What does purchasing power parity (if applied only to the price of the burger) say those currencies should have done compared to the dollar? Did they? **<a: Their currencies should have gotten cheaper. They did not, except in Japan.>**
- What seems to have happened here, according to the *Economist*? **<a: It's not very clear at all, but it seems that the dollar was way overvalued in January, so this seemingly perverse movement is a correction of what it was before.>**