Exchange Rates in International Business

Lectures in International Business 2004
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Global Financial Markets Are
Independent Markets
Outside the Jurisdiction of
Any One Country

An Exchange Rate
• The price of one Currency in terms of another Currency

• Money in any society derives its value from its purchasing power – the amount of want satisfying capacity it contains (the amount of goods and services it will attract in exchange).

Exchange Rates
• Are determined in Financial Markets based on the Supply and Demand for Currencies.

• Currencies have many different exchange rates dependent on the terms of the exchange.

The Foreign Currency Market is Enormous

A global network of banks, brokers, and foreign exchange dealers trade currencies Around the clock.

• These exchanges exceed:
  - U.S. $ 2,000,000,000,000. Per Day!
  - Well in excess of the U.S. GDP every week.

Exchange Rate Forecasting: Efficient School

The Efficient School: Predicts that future exchange rates are best estimated by the forward currency rates

- these rates are derived from the composite estimates in the world currency markets
- remember, these amount to in excess of US $ 2 trillion per day.
Exchange Rate Forecasting: Inefficient School

The inefficient School: Predicts that individual goods producing companies can make better (more accurate) forecasts than the combined money markets of the world. Therefore, this school says that companies can increase their profits by gambling in foreign currency markets. Two types described: fundamental (economic trends) and technical (charting).

Purchasing Power Parity (PPP):

“the rate that equalizes the price of an identical product or service in two different currencies.

Price in England = Exchange rate x price in U.S.

The Law of One Price

◊ Can be shown using the Economist magazine’s “Big Mac” index.

◊ As is clear from this one item index, factors other than the “value” of a given good play a role in either

◊ price setting in the local market,

◊ exchange rates,

◊ or both

The Bretton Woods Agreement, 1944 - 1971

◊ Fixed Exchange Rates...“adjustable peg”

◊ The International Monetary Fund (IMF)

◊ The World Bank

Fixed & Floating Foreign Exchange Rates

Floating Exchange Rates - “rates that respond quickly to market forces of supply and demand.”

Fixed Exchange Rates - “foreign currencies linked to each other based on gold.”
The Maastricht Treaty
December 1991

Outlined long-term goals for harmonized social and welfare policies for the EU
Specified a timetable for the adoption of a single currency

European Monetary System

December 31, 1998: Exchange rates for the 12 participating members of the Euro group of the European Union were permanently set. The Euro was a fact.

The currencies were still in circulation until July 1, 2002, but they have no independent values in world currency markets.

Their values are derived from Euro.