

BA 311 – MONEY AND BANKING

WHAT DO EXCHANGE RATES DO?

An appreciation of the (dollar) will cause the relative price of imports to _____ and exports to _____.

Why do politicians generally advocate for a “strong dollar” policy?

Can use futures contracts to hedge against currency exchange fluctuations.

Real exchange rate is the relative price of domestic and foreign goods.

May have significant influence on industries (US Steel/Auto)

REAL EXCHANGE RATE & PPP

THE BIG MAC INDEX

Coined 'Burgernomics,' the Big Mac Index has become a global standard of determining purchasing power between two currencies by comparing the cost of the McDonald's burger in any two countries.

1 OVERVIEW

The average price of a Big Mac is compared to demonstrate the value of a currency. For example, a Big Mac costs \$4.07 in the U.S. compared to \$2.27 in China. The burger is 44% cheaper in China, which suggests the yuan is 44% undervalued against the dollar.

HOW WAS IT CREATED?

The Big Mac Index was introduced in *The Economist* in September 1986 as an illustration demonstrating exchange-rate theory.



WHAT IS IT?

An informal way of measuring the Purchasing Power Parity (PPP) between two currencies - a comparison of currency value.



VARIANTS

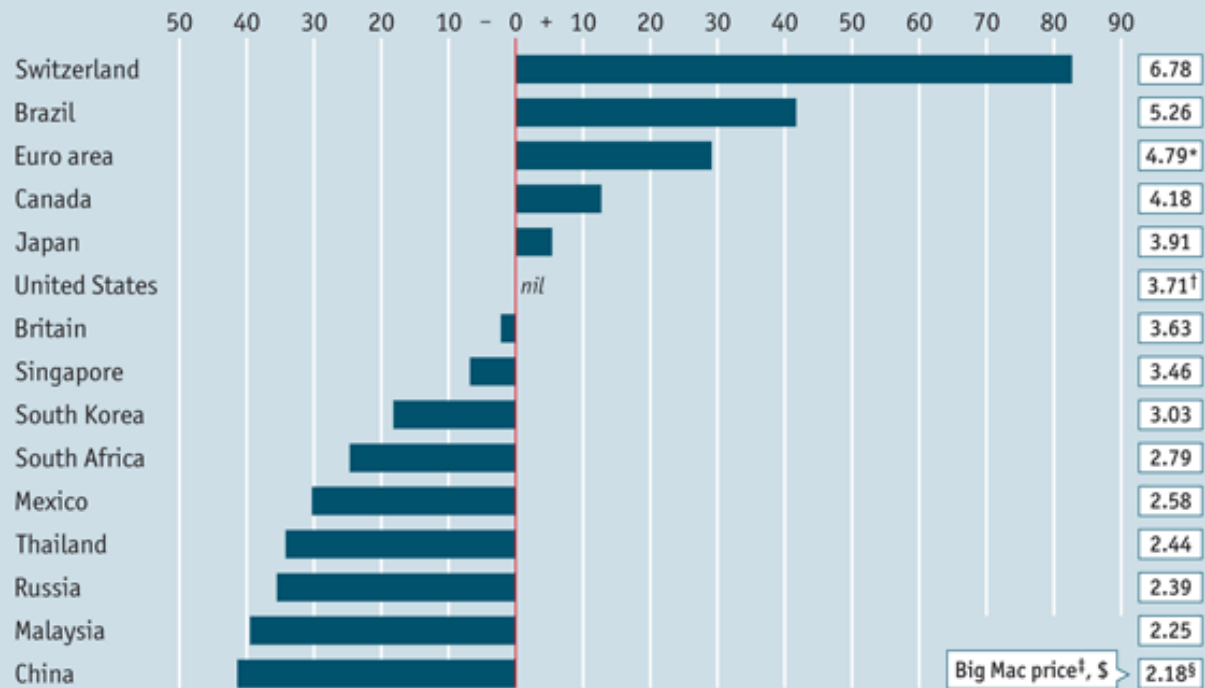
In 2004, the Tall Latte index featured a Starbucks Coffee. In 2007, the iPod Index was considered more consistent, but criticized for ignoring shipping costs. IKEA also made an appearance in 2009 with Bloomberg's Billy Index.



REAL EXCHANGE RATE AND PPP

Big Mac index

Local-currency under(-)/over(+) valuation against the dollar, %



Sources: McDonald's; *The Economist*

*Weighted average of member countries †Average of four cities
 ‡At market exchange rate (October 13th) §Average of two cities

SHORT RUN EXCHANGE RATES

Driven by supply and demand of money

PPP will eventually take over and equalize over time

Equilibrium point is where net exports equal net capital outflows – or net imports equal net capital inflows.

Rise in net capital outflows reduces the exchange rate.

Why?

Rise in net exports raises the exchange rate. Why?

CURRENCY SPECULATION

More than half the FOREX market is speculation versus hedging.

Speculators use economic forecasts, technical analysis, Ouija boards, monitoring order flows, PPP indices, and other tools of varied effectiveness.

Technical analysis (charting) looks for market psychology in price history

What types of market efficiency do these tools imply?

ASYMMETRY IN THE SYSTEM – ADVERSE SELECTION

- Adverse selection – the less desirable assets, projects or opportunities are presented to the market
- Common in many markets – real estate, cars, securities.
- Savers tend to keep best opportunities for themselves and do not sell participation in high value assets.
- High risk firms would rather sell bonds – Why?
- Downside is the same, upside inures to the common shareholders

ASYMMETRY IN THE SYSTEM – MORAL HAZARD

- Moral Hazard– It isn't my money (OPM – Other People's Money)
- Business Judgement Rule protects management
- Misalignment of priorities or incentives between management and shareholders or management and bond holders

ASYMMETRY IN THE SYSTEM – MANAGING THE RISK

- Company research – IB's, rating agencies, analyst reports, D&B, Google
- Independent directors – including institutional investor representatives – though this may create other issues...
- Proxy rights and disclosures, Derivative actions
- My old world – PE/VC Firms
- Regulation – SEC, CFPB, Sarbanes Oxley, Dodd Frank, EU
- Traditional Banking System – Commercial Banks tend to provide capital when open capital markets unavailable.
- Personal Touch & Reputation
- 5 C's – Capacity, Conditions, Character, Collateral and Capital
- Secondary and tertiary sources of repayment