CHAPTER SIX

Global Monetary Linkage

Exchange Rates

PPP

Trading for Profit

The Eurozone

Global Economy

Exchange Rates

Foreign exchange
The market where buyers and sellers trade currencies.

Exchange rate
The price of one currency in terms of another.

- Calculated using domestic currency to purchase an equivalent amount of foreign currency

Appreciation and depreciation assist in understanding the equivalency of the currencies.

- Appreciation - dollars have gained more value than the other type of currency
- Depreciation - dollars have lost value against the other type of currency

Exchange Rates

The interest parity condition is what makes the exchange rate work.

Interest parity condition
The equation that solves for the market's equilibrium exchange rate.

$$R_{US} = R_{UK} + (X^e - X)/X$$

Where R is the interest rate of the respective country, and X is the exchange rate in domestic currency per unit of foreign currency

A shift in confidence will impact the interest party condition.

Figure 6.1: The Foreign Exchange Market

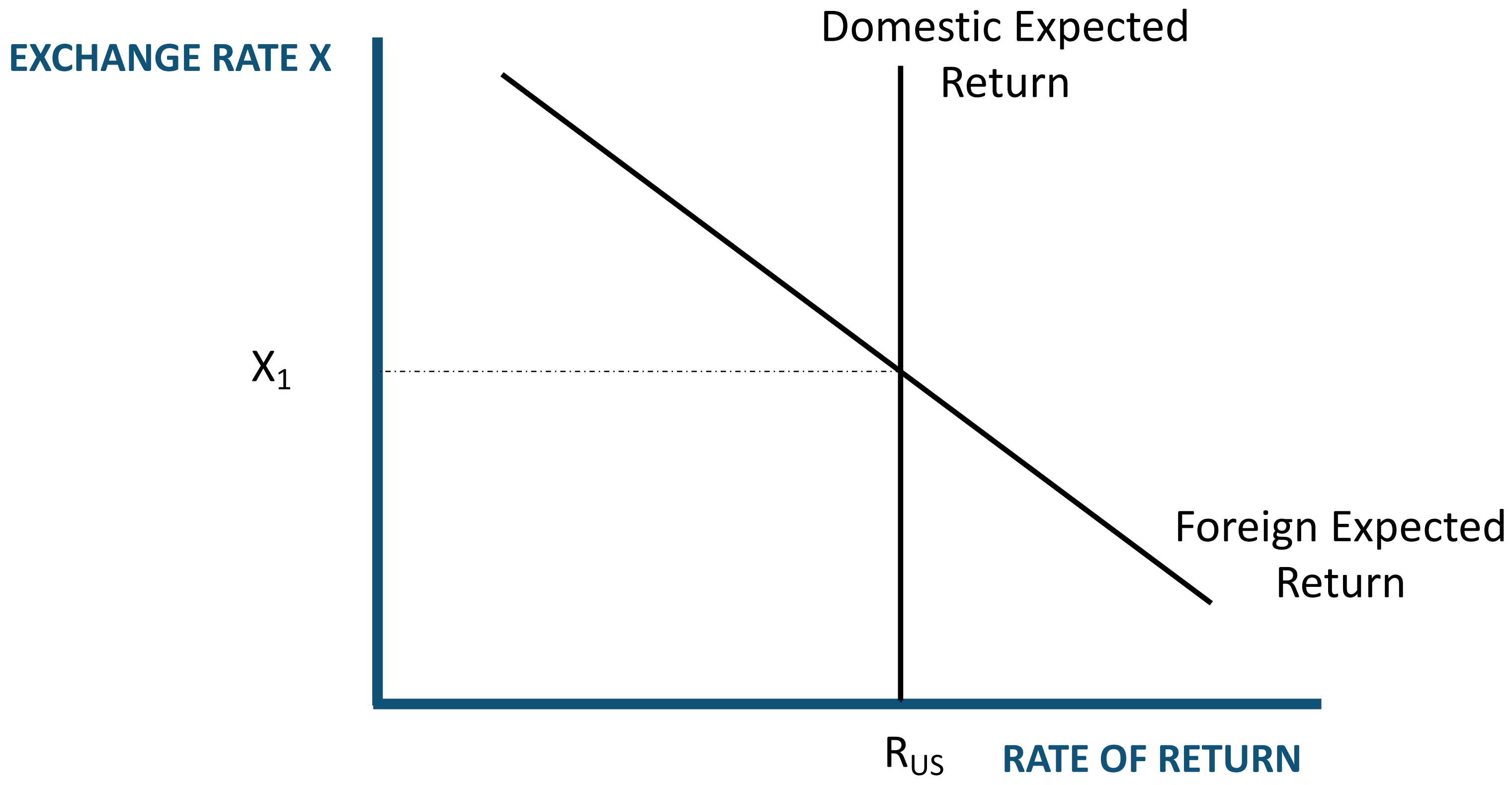


Figure 6.2: Increase in Domestic Interest Rate Effect on Exchange Rate

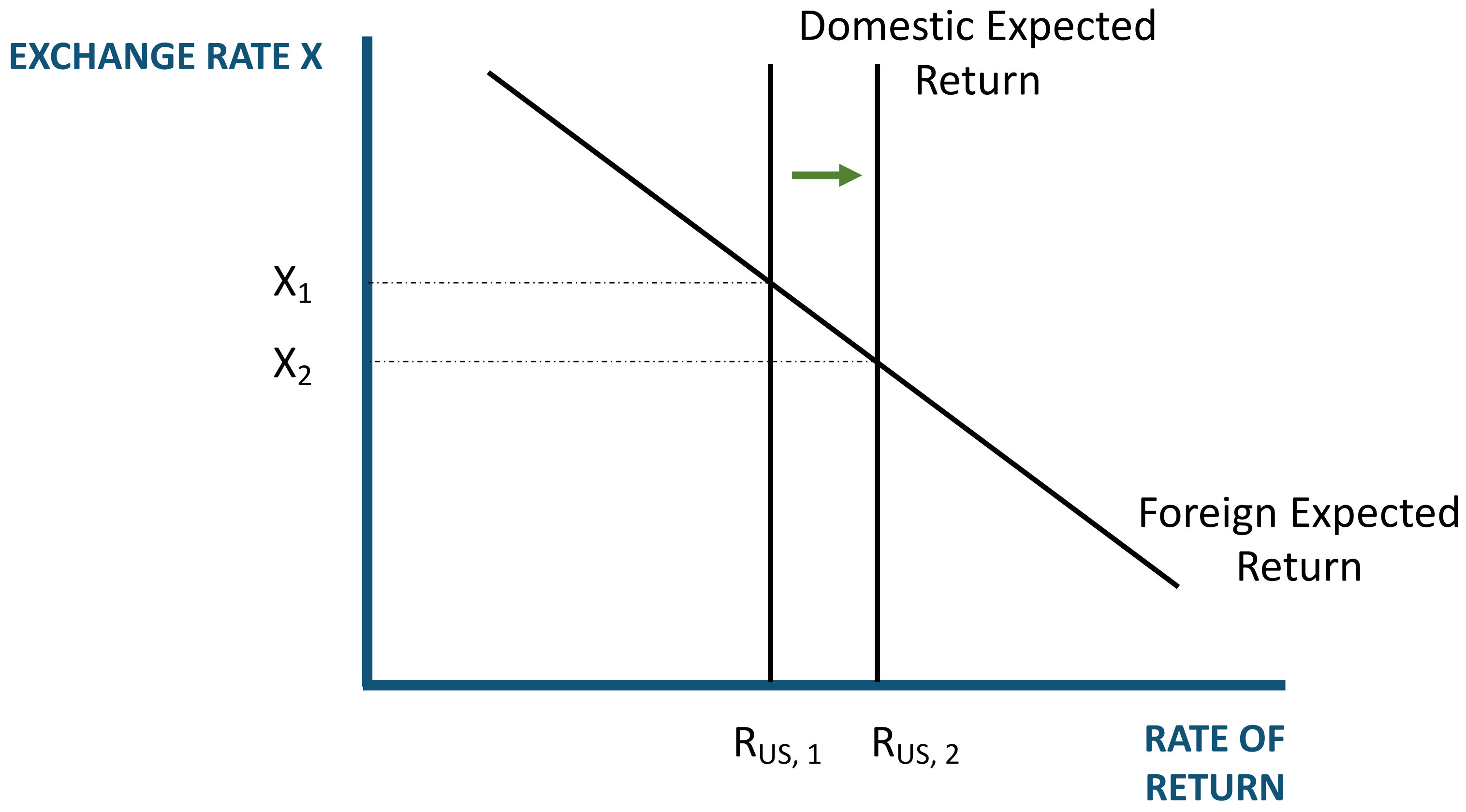
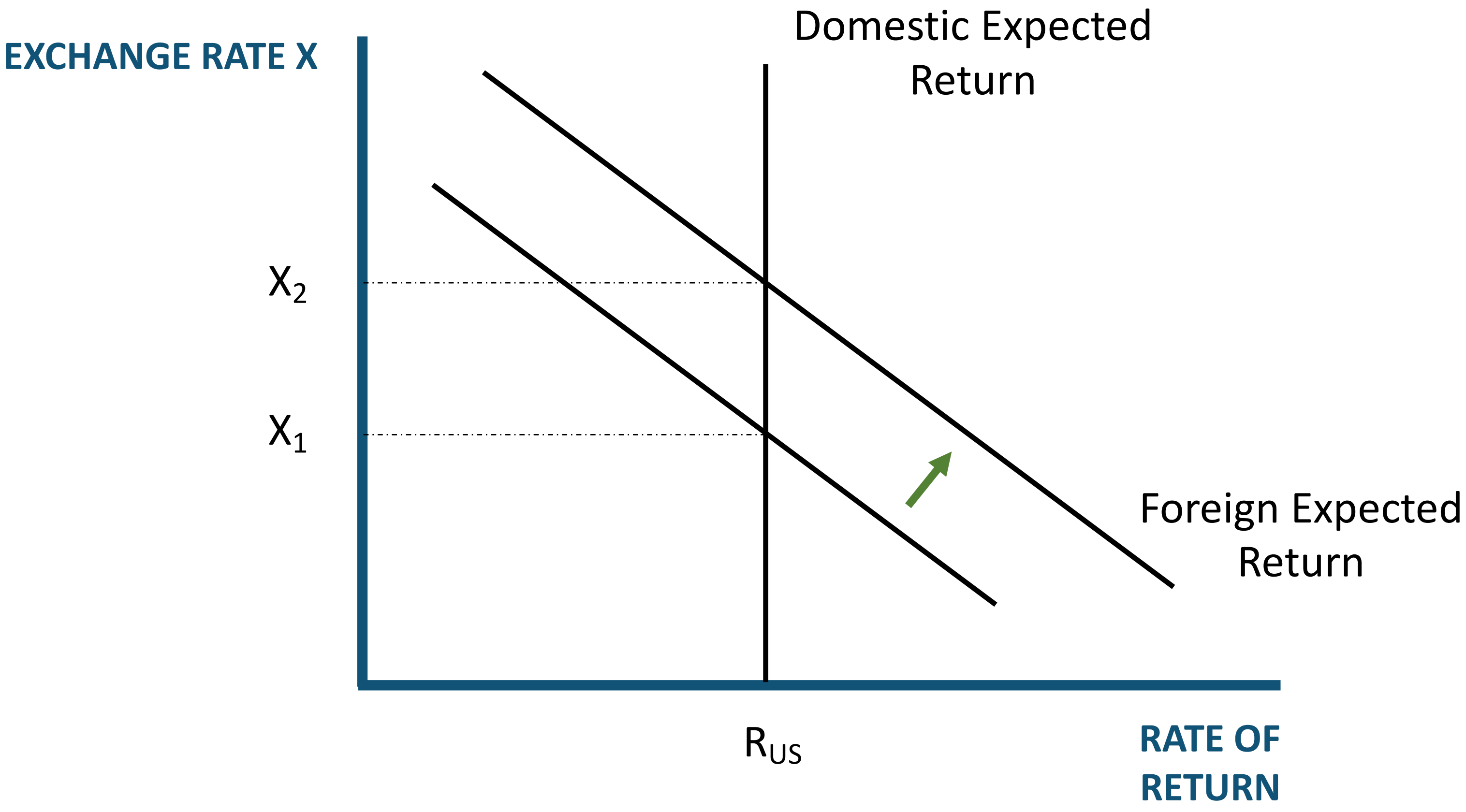


Figure 6.3: Increase in Foreign Interest Rate Effect on Exchange Rate



Purchasing Power Parity (PPP)

Purchasing power parity
An indicator of movement in foreign exchange rates.

The theory that tells us that the exchange rate is the ratio of prices in one country relative to another.

$$X = P_{US}/P_M$$

Purchasing Power Parity (PPP)

Purchasing power parity returns trading values back to equilibrium, which is known as arbitrage.

Arbitrage
When trading occurs between markets when a good or service is priced differently; the trades bring prices into parity.

- Arbitrage has the ability to bring the economy back into equilibrium.

Many economists believe that PPP may not be useful at predicting exchange rates at specific moments in time but can provide a more useful longer-term benchmark of where the true value of currency should lie.

Trading for Profit

Currency trades, or currency swaps, are typically executed in pairs and are accomplished through contractual agreements and derivatives.

- The buyer is simultaneously buying one currency and selling another
- Profit is realized when the trader sells the currency that has a falling value and gains a currency that has a rising value

The most common players in this type of trade are banks.

By using reserves, banks use their own capital to bring in profits.

Trading for Profit

Government policies add risk to trading for profit and drive the market in unpredictable directions.

Additional players in this trading game include businesses.

- Attempting to avoid loss from an excessive negative currency movement
- Like-minded businesses pursuing different goals work together toward a mutually benefitting from the trade

Forward Exchange Contracts
An agreement to buy or sell currency at an agreed upon future date for a predetermined exchange rate.

The Eurozone

Eurozone
A subset of European Union countries that share the same currency, the Euro, and have a shared monetary policy.

- Comprised of 19 European countries
- purpose of creating a trading block of countries unified by a common new currency, the euro, to increase trade with each other and with the entire world

Identified flaw in The Eurozone – the European central bank never implemented a unified fiscal policy (when some countries outperform others).

The Eurozone

Optimum Currency Areas (OCA)
A specific area, usually geographic, where a single currency would provide the greatest economic benefit to member nations.

- Eurozone members do not have the ability to issue their own currency, which leads to debt
- the theory of optimum currency areas (OCA) is often applied to the eurozone

Global Economy

Each country is part of the global economy.

Every action one country takes impacts the others, especially economically – it is crucial to be aware of interconnectedness of our world.

One economic decision has the potential to impact the global economy.

Confidence is key in the global economy.