

4

Exchange Rate Determination

CHAPTER OBJECTIVES

The specific objectives of this chapter are to:

- Explain how exchange rate movements are measured.
- Explain how the equilibrium exchange rate is determined.
- Examine factors that affect the equilibrium exchange rate.
- Explain the movements in cross exchange rates.
- Explain how financial institutions attempt to capitalize on anticipated exchange rate movements.

WEB

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EXAMPLE

Financial managers of multinational corporations (MNCs) that conduct international business must continuously monitor exchange rates because their cash flows are highly dependent on them. They need to understand what factors influence exchange rates so that they can anticipate how exchange rates may change in response to specific conditions. This chapter provides a foundation for understanding how exchange rates are determined.

4-1 Measuring Exchange Rate Movements

Exchange rate movements affect an MNC's value because they can affect the amount of cash inflows received from exporting products or services or from a subsidiary; likewise, they can affect the amount of cash outflows needed to pay for imports of products or services. An exchange rate measures the value of one currency in units of another currency. As economic conditions change, exchange rates can change substantially. A decline in a currency's value is known as **depreciation**. When the British pound depreciates against the U.S. dollar, it means that the U.S. dollar is strengthening relative to the pound. An increase in currency value is known as **appreciation**.

When a foreign currency's spot rates at two different times are compared, the spot rate at the more recent date is denoted as S and the spot rate at the earlier date is denoted as S_{t-1} . The percentage change in the value of the foreign currency over a specified period is then computed as follows:

$$\text{Percent } \Delta \text{ in foreign currency value} = \frac{S - S_{t-1}}{S_{t-1}}$$

A positive percentage change indicates that the foreign currency has appreciated over the period, whereas a negative percentage change indicates that it has depreciated over the period.

On some days, most foreign currencies appreciate against the dollar (albeit by different degrees); on other days, most currencies depreciate against the dollar (again, by different degrees). On still other days, some currencies appreciate while others depreciate against the dollar; the financial media describe this scenario by stating that "the dollar was mixed in trading."

Exchange rates for the Canadian dollar and the euro are shown in the second and fourth columns of Exhibit 4.1 for the months from January 1 to July 1. First, observe that the direction of the movement may persist for consecutive months in some cases, but in other cases may fluctuate. The magnitude of the movement tends to vary every month, although the range of percentage movements over these months

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International Financial Management Jeff Madura, 2003 The student CD ROM contains the following projects and supplements Real time web project Running your own MNC Online analysis of an MNC International investing project An internet connection is required for full some applications Finance Literature Index ,1994 **The McGraw-Hill Finance Literature Index** ,1996 **Mcgraw-Hill Finance Literature Index** Jean Louis Heck,1996 **Financial Markets: Derivative and foreign exchange markets** Jeff Madura, 2004 Illustrates the progress that has been made in financial markets and assesses innovations that provide solutions to dilemmas and increase efficiency These articles break down the complex web of relationships between the financial intermediary the managers of corporations shareholders creditors analysts and regulators *Comprehensive Dissertation Index* ,1989 **Aanwinsten van de Centrale Bibliotheek (Queteletfonds)** Bibliothèque centrale (Fonds Quetelet),1995 *Dissertation Abstracts International* ,1986 Exchange Rate Determination and Adjustment Jagdeep S. Bhandari,1982 *Exchange Rate Determination Puzzle - Long Run Behavior and Short Run Dynamics* Falkmar Butgereit,2009-07-02 Inhaltsangabe Introduction As the foreign exchange rate market operates twenty four hours a day and seven days a week it can be described as a global marketplace trading in continuous time The importance of this market place on weal and woe of economies and agents cannot be overestimated Long lasting disputes about exchange rate over and under evaluation between countries as most prominently the case between China and the USA and its implications for international trade growth rates of economies unemployment levels financial money flows and so forth illustrate this point As reported by the Bank of International Settlement in its triennial Central Bank Survey 2007 covering 54 countries and jurisdictions the daily average foreign exchange turnover as of April 2007 has reached a mind staggering 3 21 trillion This amount marks an increase of 69 percent compared to the 1 97 trillion three years earlier and highlights the still increasing importance of the exchange rate markets The U S dollar is by far the most important currency as it is involved in 86 percent of all transactions amounting to some 2 7 trillion per day This is by far bigger than the volume of U S international trade in goods and services which for the month April 2007 amounted to imports exports 317 5 billion 1 Indeed only 17 percent of exchange market turnover has been reported to occur with non financial customer counterparties while 43 percent of transactions occur between reporting dealers i e the interbank market and 40 percent occur between reporting and non reporting financial institutions e g hedge funds mutual funds pension funds insurance companies Accordingly more than 2 3 of the turnover was traded as derivatives such as foreign exchange swaps outright forwards or options while only 1 3 constituted spot rate transactions These are important facts to consider when talking about forces of exchange rate determination On ground of these figures one may reasonably explain why old fashion standard models like the monetary model or purchasing power parity may only hold in the very long run and exchange rate movements may be much more subject to trades based on heterogeneous expectations incurred by investors speculators and market makers

Particularly at the short run exchange rates exhibit considerably greater volatility than macroeconomic time series leaving an impression of noisy and chaotic behavior Throughout this work it

Three Essays on the Empirical Aspects of Models of Exchange Rate Determination Michael Kirk Pippenger,1990 **Exchange-rate determination** A.O. Krueger,1990

A Model of Foreign Exchange Rate Determination Tara J. Gill,1980 *Exchange-Rate Determination* Anne Osborn Krueger,1985 Difference-Equations Solution of Exchange Rate Dynamics Hiroya Akiba,2004 The paper focuses on an appropriate and consistent theoretical as well as empirical model of the rational expectations version of the asset market approach to exchange rate determination Using a sticky price monetary model and formulating the model by a difference equations system explicit solutions are obtained as functions of forcing variables extending to past dates only This backward looking characteristic of the solution is in stark contrast to conventional forward looking models and alleviates empirical investigation because of the need for past data only This discrete dynamic model is superior to the corresponding continuous model because its solutions neither exhibit the empirically unfounded overshooting behavior nor have saddle point in stability Rather the exchange rate is shown to follow an oscillatory path with asymptotic stability and this seems to replicate the actual movements closely approximated by a random walk process Exchange-rate Determination Peter Isard,1978

Exchange-rate Determination Anne O. Krueger,1983 *Forward Market Efficiency and Foreign Exchange Rate Determination* Jigeng Lin,1994 **A Simple Long-run Model of Exchange Rate Determination** John F. O. Bilson,1979

Exchange Rate Determination and the Demand for Money Craig Stephan Hakkio,1981 This paper examines the conventional monetary equation of exchange rate determination Under certain exogeneity conditions one can write the price level at home and abroad as the ratio of the nominal money supply to the demand for real money balances Then since the exchange rate is the domestic price of foreign exchange one can equate the exchange rate to the ratio of domestic to foreign prices This then allows one to write and estimate the exchange rate as a function of the money supply differential income differential and interest rate differential If the domestic and foreign money demand errors are autocorrelated and if deviations from purchasing power parity are autocorrelated tests based on the above model may be invalid Only if all autoregressive parameters are equal will test results be valid A full information maximum likelihood procedure is used to estimate and test the assumptions necessary for the conventional procedure to be correct Finally two alternative models of exchange rate determination are considered to illustrate the importance of introducing the error terms at the beginning of the analysis

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