

## **LEARNING OBJECTIVE 6.1 Identify the three functions of money.**

The three functions of money are to facilitate trade, to serve as a unit of accounting, and to enable the storage of value so that people can delay consumption (save). Historically, currencies were either made of valuable materials like precious metals or were backed by such materials. Today, most governments have shifted to fiat currencies, or currencies that have value only because the government says they do.

### **Money acts as:**

- **Medium of exchange**
  - conduct transactions without having to wait for what economists call a “double coincidence of wants” in which, say, I want your car and you want my airplane, so we simply trade
- **Unit of account**
  - makes it easier for people to agree on the value of goods and trade with each other
- **Store of value**
  - allows people to save it and delay consumption from today into the future. For instance, it is a lot easier to carry paper money around than chickens, cars, or airplanes
  
- Before 1973, for instance, the currency of the United States (and those of many other countries) was based on the **gold standard**
  - a currency where the value is determined by the ability to trade it for a specified amount of gold (i.e., \$1 for 1 / 35 of an ounce) at a government-approved bank
- Since the 1970s, however, most of the world’s currencies have been **fiat currencies**.
  - a currency that the government has declared to be legal tender but is not backed by any physical commodity
    - fiat currency can be worth more or less in international markets depending on how trustworthy the government is that printed it, and the available supply of and level of demand for the currency

## **LEARNING OBJECTIVE 6.2 Explain why foreign exchange rates fluctuate.**

Today’s fiat currencies are valued based largely on factors such as supply and demand, political stability, and economic policy. Exchange rates are based on purchasing power parity (PPP) and the law of one price, which imply that identical goods should have the same prices across country borders. Currencies manipulated by their governments can be either under- or overvalued, depending on whether they buy less or more foreign goods than predicted by PPP.

- The value of a **fiat currency**—like the U.S. dollar or the European euro (€)—relative to the value of any other fiat currency is influenced by individuals' perceptions of the currency's value
- **appreciation**: an increase in the value of one currency relative to another currency
- **depreciation**: a decrease in the value of one currency relative to another currency
- **exchange**: rate the value of one currency when being converted to another currency

### **Main types of government policy affect currency valuations and foreign exchange rates**

1. International Monetary Fund (IMF), 29 countries **allowed their currencies to float**, meaning that their governments do not explicitly or directly influence the price of their currency by directly intervening in currency exchange or by limiting currency flows
2. 36 countries engage in a **managed float**, or dirty float, meaning that they generally don't interfere in the value of the currency, but they will explicitly intervene if their currency depreciates or appreciates beyond a certain amount.
3. Some countries **peg or fix their currency to a foreign currency** or a basket of currencies—usually stronger or more stable ones (Saudi to USD)
4. some countries **abandon** their currency altogether and use U.S. dollars or another currency instead. This practice is known as dollarization (Zimbabwe ZOLLARS)

The BIS has a mission to help central banks achieve stability and to foster international cooperation by acting as a bank for central banks

- London is the center of the foreign exchange universe and accounts for roughly 37 percent of the global volume. New York is second, with 19 percent; other cities such as Hong Kong and Singapore also facilitate a large share of global exchange.
- **spread** the difference between the buy and sell price for a currency
- **spot exchange rate**: buying foreign currency at present-day rates in anticipation of future transactions

**Big Mac Index** a tool developed by the Economist magazine that demonstrates the over- or undervaluation of a currency as compared to the U.S. dollar using the price of the McDonalds' Big Mac

- If the Big Mac is relatively more expensive in the comparison currency than in the base currency, the comparison currency is probably overvalued.
- If the Big Mac is less expensive, the comparison currency is likely undervalued

**LEARNING OBJECTIVE 6.3** Discuss the causes and consequences of under- or overvaluation of currency.

Undervalued currencies tend to make domestic production more appealing for foreign trade, potentially boosting domestic manufacturing sectors. Overvalued currencies make it easier for a country to pay down foreign debts and for citizens to buy foreign-produced products and services. Governments sometimes interfere with natural currency values to keep foreign trade conditions more favorable for domestic industries.

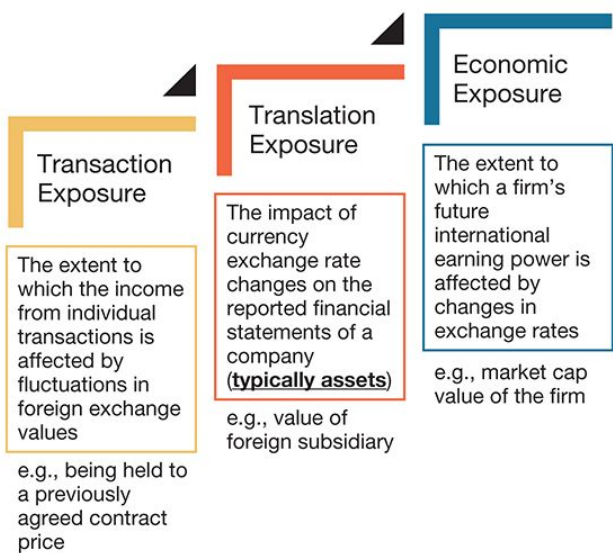
**Undervalued** : China pegged to renminbi

**Overvalued**: Japan

- Japanese goods—like cars, computers, and TVs—are relatively more expensive than the same goods produced by foreign rivals simply because of the high price of the yen.

**LEARNING OBJECTIVE 6.4 Describe how companies settle international monetary transactions and manage exchange rate risk.**

Three types of exchange rate risk—transactional, translational, and economic—can affect company profits, earnings, and balance sheets. Three major tools—spot exchanges, forward contracts, and currency swaps—help firms eliminate currency risk by locking in an exchange rate, whether payment is made now or in the future. Companies can also avoid risky situations by considering countries’ current and expected rates of growth, level of foreign direct investment, fiscal and monetary policies, and political stability.



**Managing Exchange Rate Risks**

- companies can take advantage of **spot exchange rates**. This simply means buying foreign currency at present-day rates in anticipation of future transactions.

- **forward exchange rate transactions** a transaction involving two parties that agree to exchange currency at some future date at a specific rate they agree to at the time of the deal
- **FX swaps** the simultaneous purchase and sale of a given amount of currency at two different rates
- **An option** is the purchase of the right to buy a certain amount of currency at a given exchange rate, but is not an obligation to buy
- **A future** is similar to a forward contract, but rather than purchasing it from a bank, it is traded on an exchange

### **Predicting Exchange Rate Shifts**

- **Economic Growth**
  - Strong economic growth is a sign that a nation's currency will appreciate in value against other currencies, because a nation's growth means its people have rising levels of disposable income and will need more places to spend it.
- **Foreign Direct Investment**
  - foreign companies or individuals decide to invest in a country by purchasing land, constructing production facilities, or hiring and training new workers, they create demand for that currency
- **Monetary and Fiscal Policies**
  - Monetary policies are the methods by which a central bank attempts to control the supply of its currency
  - Central banks can also raise interest rates and use quantitative easing as tools to try to manage their currency to the advantage of their own economy
- **Political Stability**