

Accounting for recent movements in the dollar



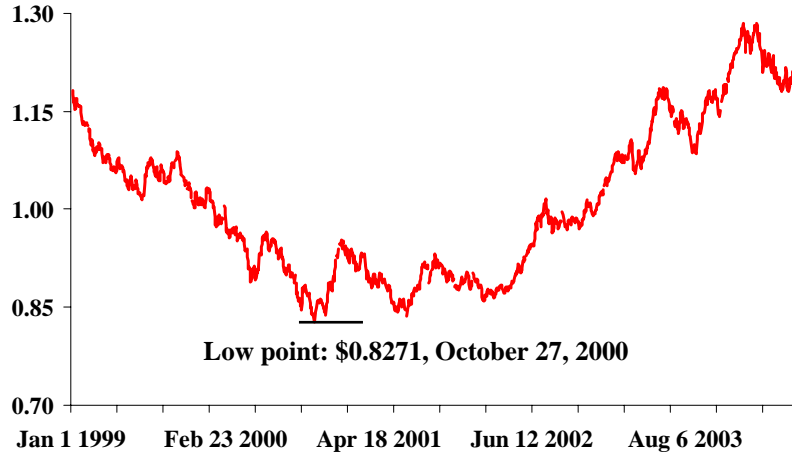
Overview

- The basic facts
 - How much has the dollar fallen?
- Accounting for exchange rate movements
- The dollar and the current account
- International role of the dollar



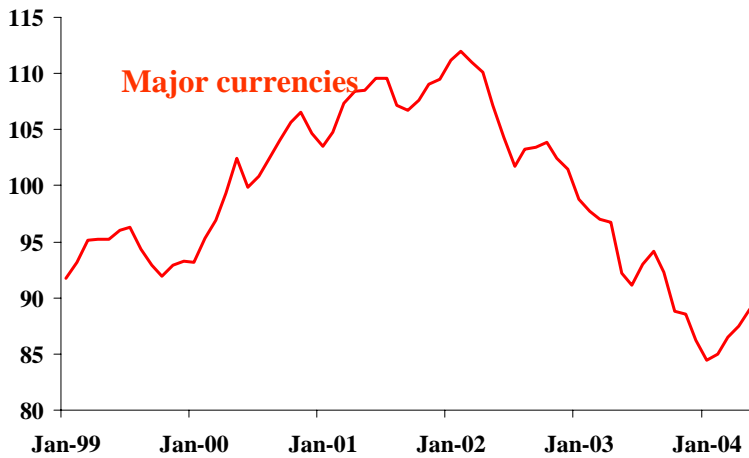
Dollar-euro exchange rate

Dollars per euro

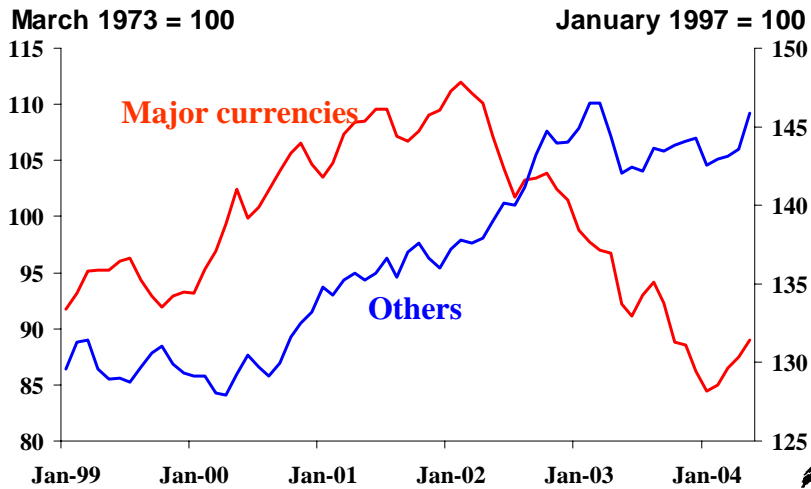


Dollar against major currencies

March 1973 = 100



Major currencies versus others



Proximate reasons for recent decline

- Dollar was “overvalued”
 - Decline inevitable
- Concerns about strength of recovery and long-term prospects
 - U.S. less appealing as destination for capital
- Kybernanophobia
 - U.S. less appealing as destination for capital



Forecasting movements in exchange rates

- Meaning of over- or undervaluation
 - We know the “correct” value
- Reality
 - Tossing a coin just as good
- “Overvaluation” a political statement



Explaining over- and under-valuation

- Purchasing power parity doctrine
 - Exchange rates adjust to equate the prices of identical goods
- Law of one price
 - Identical goods sell for the same price



The Big Mac standard

- Price of Big Mac in U.S.:
= \$2.80
- Exchange rate:
= \$1.25 per €
- Price of Big Mac in Europe:
= \$3.48 (at market exchange rates)
- Overvaluation of the euro against the dollar:
= 24 percent = $\$3.48/\$2.80 - 1$



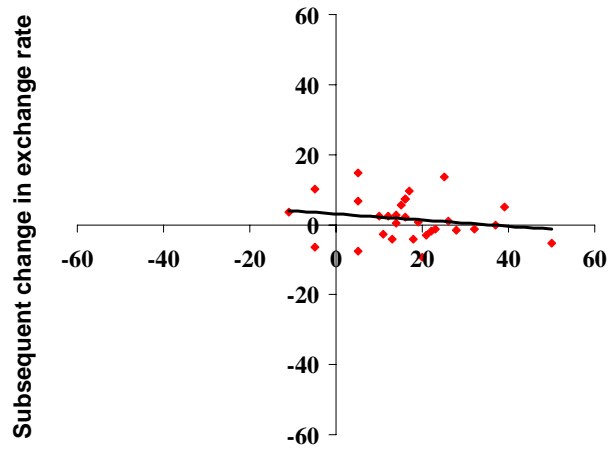
The Big Mac standard II

- Price of Big Mac in U.S.:
= \$2.80
- Exchange rate:
= 8.28 RMB ¥ per \$
- Price of Big Mac in China:
= \$1.23 (at market exchange rates)
- Undervaluation of renminbi:
= 56 percent = $1 - \$1.23/\2.80



UK and Germany/Euro

Horizon: 6 months

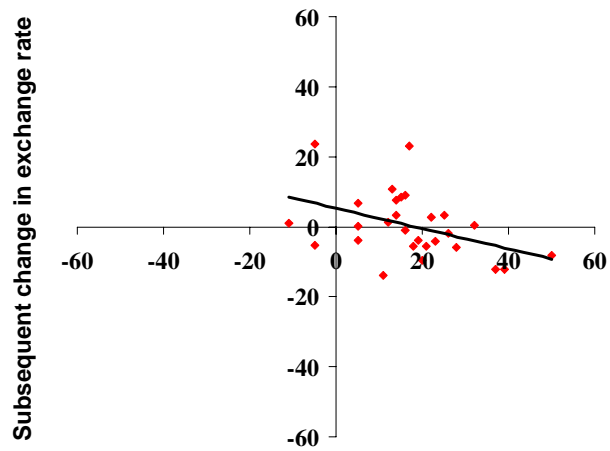


Overvaluation (+) against the dollar



UK and Germany/Euro

Horizon: 12 months

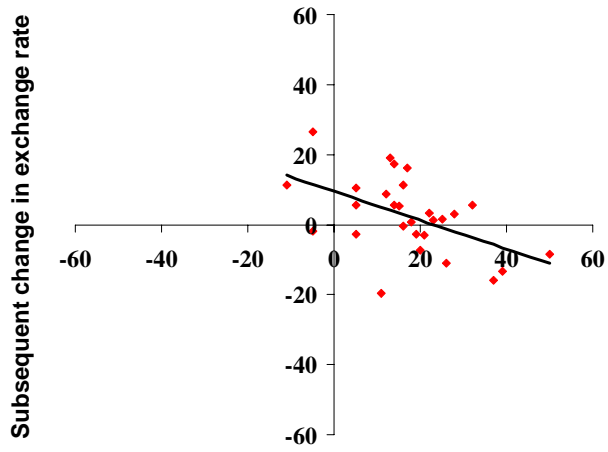


Overvaluation (+) against the dollar



UK and Germany/Euro

Horizon: 18 months

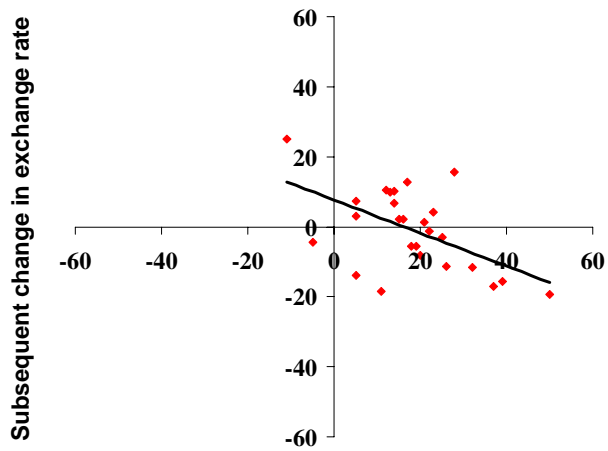


Overvaluation (+) against the dollar



UK and Germany/Euro

Horizon: 24 months

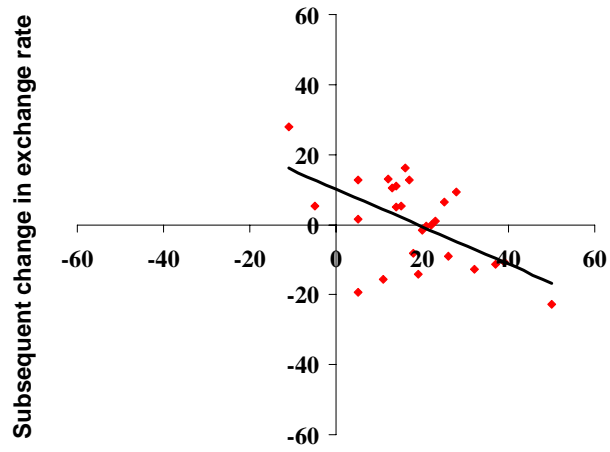


Overvaluation (+) against the dollar



UK and Germany/Euro

Horizon: 30 months

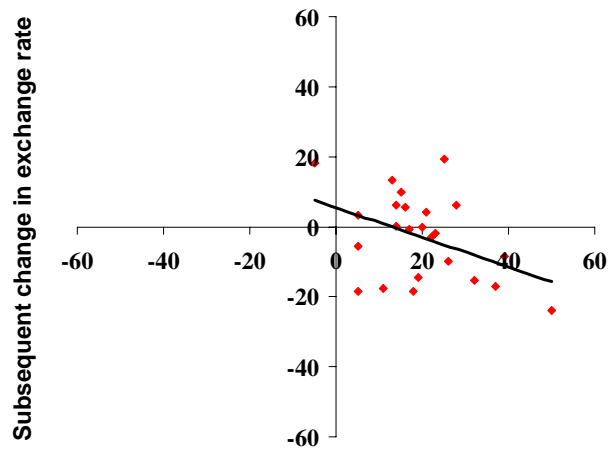


Overvaluation (+) against the dollar



UK and Germany/Euro

Horizon: 36 months

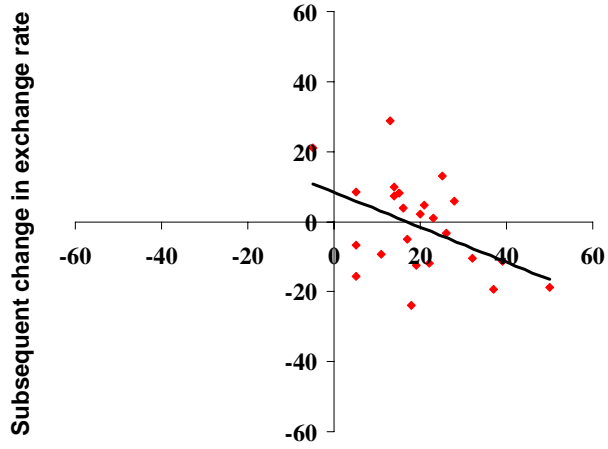


Overvaluation (+) against the dollar



UK and Germany/Euro

Horizon: 42 months

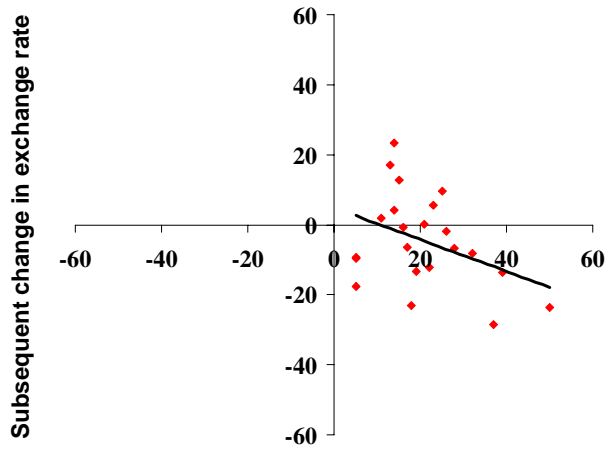


Overvaluation (+) against the dollar



UK and Germany/Euro

Horizon: 48 months

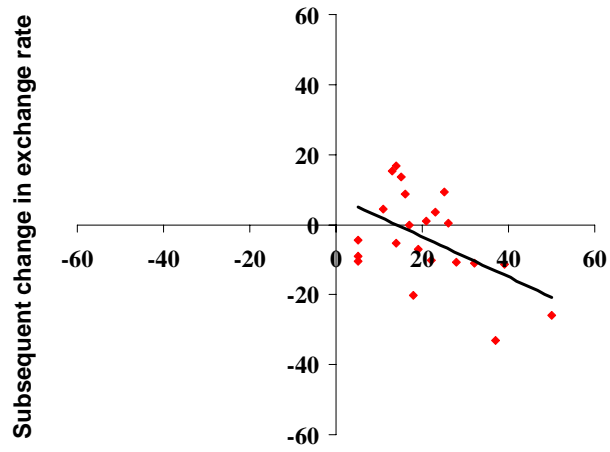


Overvaluation (+) against the dollar



UK and Germany/Euro

Horizon: 54 months

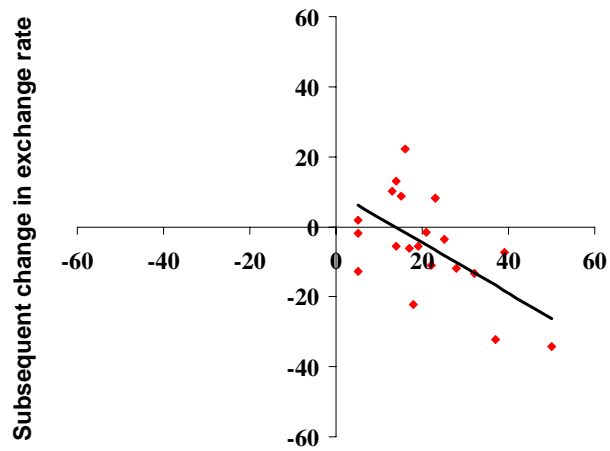


Overvaluation (+) against the dollar



UK and Germany/Euro

Horizon: 60 months



Overvaluation (+) against the dollar



The Big Mac standard

- Real exchange rate between Big Macs in U.S. and Europe:
= $(\$2.80 / 1.25 (\$ \text{ per } \text{€})) \cdot (1/\text{€}3.48)$
= 0.64 European Big Macs per U.S. Big Mac

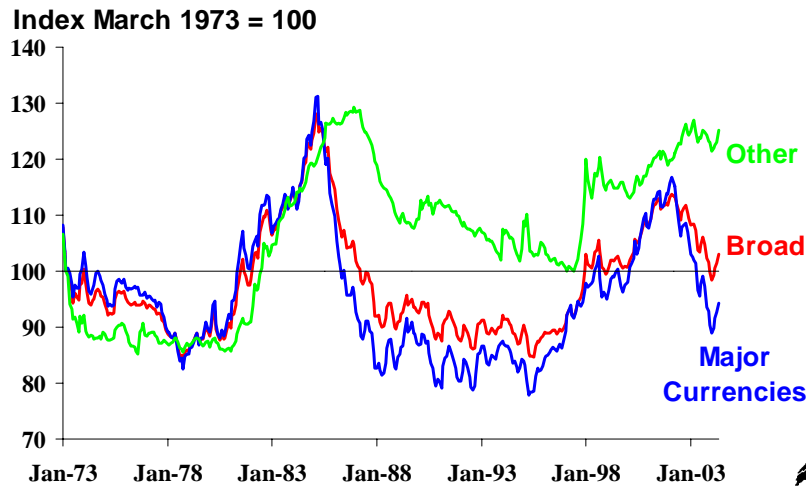


Real exchange rate

- Real exchange rate between the dollar and the euro:
= Nominal exchange rate \cdot
(Price level in U.S. / Price level in Europe)



Real trade-weighted value of the dollar

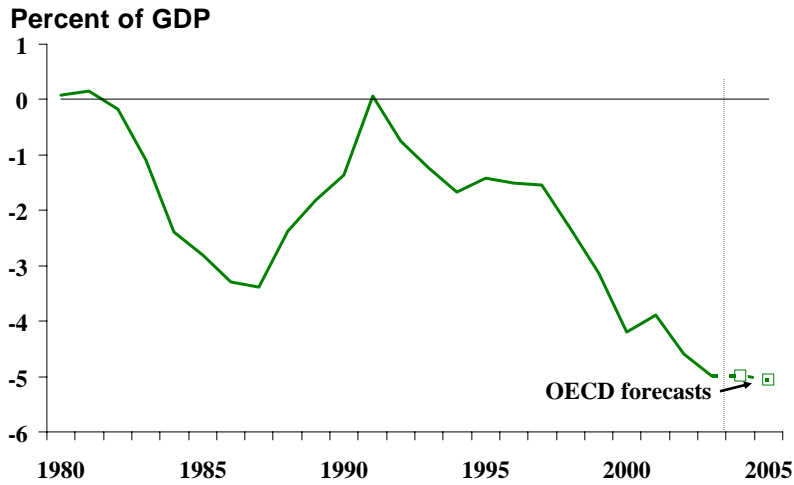


A theory of exchange rates

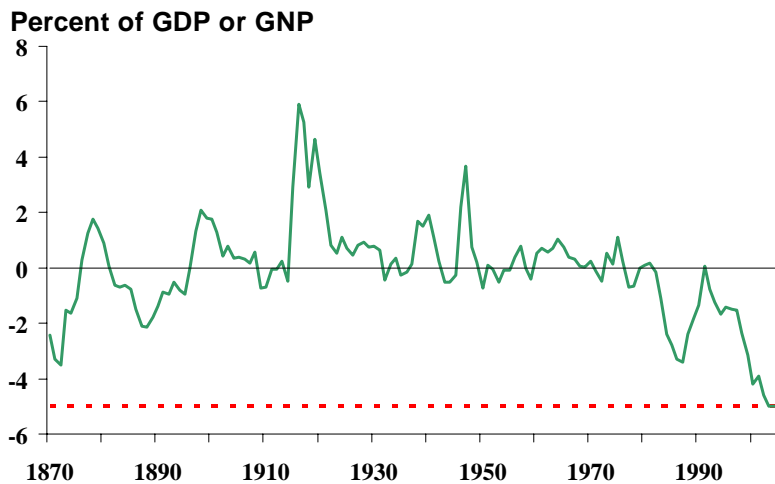
- Nominal exchange rate between the dollar and the euro:
= Real exchange rate \uparrow
(Price level in Europe / Price level in U.S.)



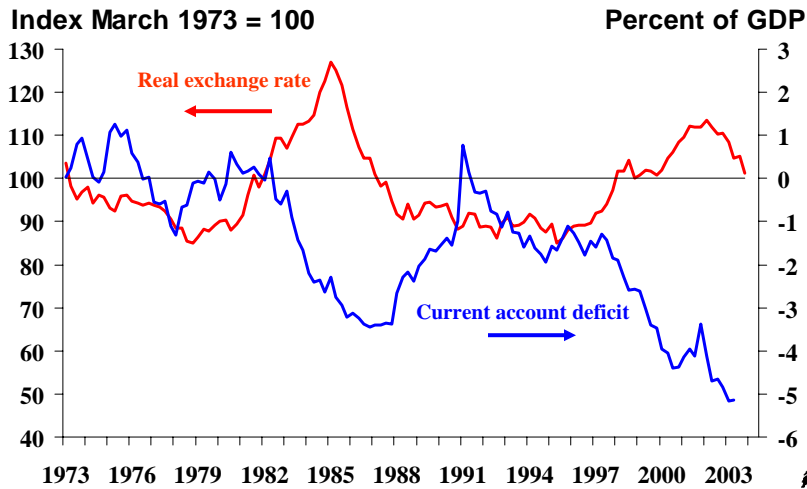
U.S. current account deficit



Historical perspective on U.S. current account deficits



Current account and the dollar



A dollar crisis?

- U.S. is different
 - Institutions
 - Currency mismatch
 - Depth and liquidity of markets
 - Risk and return combination

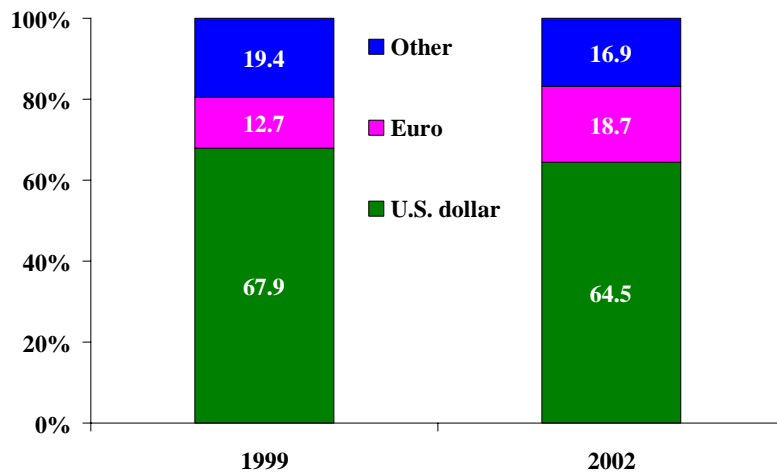


Dollar as international currency

- Dollar still preeminent
 - Pegging currency
 - Invoicing (oil, aircraft)
 - Reserve currency
 - Use in transactions
- Competition from euro



Composition of global foreign exchange reserves



Conclusions

- Recent fall in the dollar
 - Orderly
- Dollar remains above lows of past two decades
- Dollar retains its role at the center of the global financial system
 - Some erosion probably inevitable



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"It's just a flesh wound. I got it defending the dollar."

