World Currency Exchange Rates & the Foreign Exchange Market

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Introduction

This paper gives an overview of currency exchange rates, both fixed and floating, and the foreign exchange market. Included is a discussion of the many factors that influence the exchange rate between two currencies, as well as a background of world exchange rates. This topic includes a look at the fixed rated period of Bretton-Woods and the following floating exchange rate period after 1971. The floating exchange rate period is characterized by highly volatile exchange rates. I have graphed the exchange rates and volatility of Britain, Japan, and Germany to illustrate the volatility. Many have modeled the exchange rates to try and understand and predict their movements over time. Some of these models will be included within this paper, with references given for those not examined here. Lastly, a current look at the state of the US dollar is given, along with the causes that have led to its current weakened state. To conclude I have discussed how one might structure their portfolio to hedge against the dollar decline, and profit from the seemingly inevitable fall in the dollar.

Exchange Rates and the Foreign Exchange Market (Forex)

Many countries in this world have their own form of currency, but not all. The United States Dollar (USD), for example, is used in nations such as Ecuador, El Salvador, and East Timor which all adopted the US dollar as their currency independently. The nations of Palau, the Federal States of Micronesia, and the Marshall Islands were formerly members of the US-administered Trust Territory of the Pacific Islands and chose to retain the US dollar as their currency even after becoming independent in 1986. The British Virgin Islands and the Turks and Caicos Islands also us the US dollar as their local currency. The process of using the US dollar as their official currency is called *dollarization*. Some nations like Bermuda,

the Bahamas, and Panama, to name a few, have their own currencies but also freely exchange the US dollar at a 1:1 ratio. Other nations, like Belize, convert their local currency to the USD at a 2:1 ratio.

While the US dollar is the most widely used currency in the world, the CIA World Fact Book lists 178 different forms of currency. In the arrangements described above where one domestic currency can be traded at a 1:1 or 2:1 ratio it is simple to understand how the exchange of currencies and goods can take place. But not all currencies have this simple arrangement and are certainly not all equal in value. For example, ten Japanese yen will not buy the same amount of goods as ten British pounds. So how can we compare the two currencies? Another idea is: how much would the same amount of goods cost in both British pounds and Japanese yen? This question is important to individuals and businesses alike. When a person travels overseas or abroad, they need to know how much their domestic currency will be worth abroad. Will it be cheaper or more expensive to buy food, travel and accommodation comparable to what they would buy at home? Businesses also must consider this concept when importing or exporting goods or services to other countries, or when paying a salary to employees or executives abroad.

So how do we determine the value of one currency against another? The price of one nation's currency in terms of another is called the *exchange rate*, also known as the foreign-exchange rate, forex rate, or FX rate. For example, an exchange rate of 115 Japanese yen (JPY, ¥) to one USD dollar (USD, $) means that if you had 115 JPY you could exchange it for 1 USD. This is not to be confused with the cost of goods, however. A popular example used is the cost of a Big Mac in the United States versus abroad. In the United States a Big Mac costs an average of $2.90. The cost of a Big