Your Money and You

A college student's guide to money management

From the desk of the Money Page Editor

It has been a fast 16 weeks for the Money Page. The Money Page was a new idea for the Fall 2000 semester with the goal to make students and the community at Penn State Behrend more aware of the financial stories and happenings around the world as well as in the United States.

My editorial column is an effort to introduce the community at Behrend to investing and money management, using the simplest terms and examples possible, so even nonbusiness majors can grow an interest in the financial world that surrounds us.

The time has come for you, our readers, to respond to us with your frank opinions and suggestions that would help us make this a better and more educational, yet enjoyable reading.

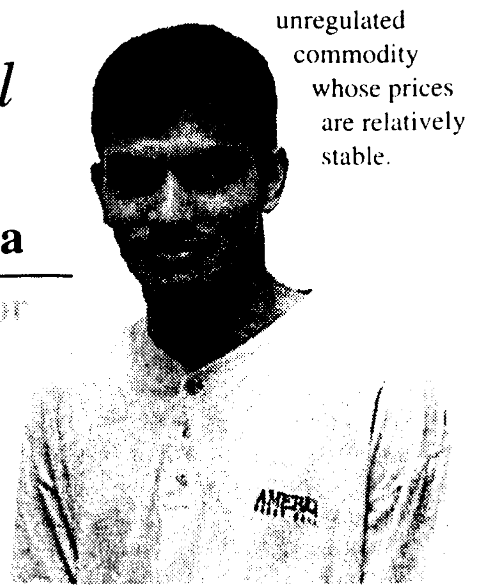
Please email any comments, suggestions or complaints to axs428@psu.edu Thank you for reading the Money Page and have a very fruitful semester.

Amortya Sinha
Money Page Editor
2000 - 2001

Monetary exchange rates and how they are set 101

Financial Outlook

Amortya Sinha
money page editor



The price or demand for a country's money (or currency) in relation to another country's money is known as the exchange rate. An exchange rate is "fixed" when countries use gold or another standard that has been agreed upon mutually and each currency is worth a specific measure of the metal or other standard. It is "floating" when supply and demand or speculation sets exchange rates. If a country imports large quantities of goods, the demand will push up the exchange rate for that country, making the imported goods more expensive to buyers in that country.

As the goods become more expensive, demand drops and that country's money becomes cheaper in relation to the other countries' money. Then the country's goods become cheaper to buyers abroad, demand rises, and exports from the country increase. The value of a currency is a relative concept or its value is equal to the worth of the goods and services that it buys. Now these same goods and services are likely to be available in various countries, with their prices, of course set in their local currency.

This relationship allows us to describe the value of one currency in terms of another and arrive at an exchange rate. Thus, in theory, the exchange rate between two currencies should be the ratio of the prices of goods and services (in local currency) in the corresponding countries.

However, there are many problems and exceptions to the above theory: one of which is that every country has different goods and services. Thus in practice, the exchange rates are set mostly by the demand and supply for a currency, which in turn depends on the trade balances and capital flows.

World trade now depends on a managed floating exchange system. Governments act to stabilize their countries' exchange rates by limiting imports, stimulating exports, or devaluing currencies.

A brief history of currency

During the history of mankind, different assets such as gold, silver, precious stones, spices, and tobacco leaves have been accepted as currency. Of these the most lasting and valued has been gold, which has many of the characteristics of an ideal currency: limited supply, non-degrading over long periods and measurable properties such as weight & purity. This measure using gold was also known as the "gold standard."

By the nineteenth century, governments realized that paper certificates, backed by gold collateral could be a more practical form of currency and introduced the first paper bill. However it was not until 1971when the gold standard connection with paper bills were dropped by the USA.

The beginning of currency notes also gave rise to the concept of exchange rates. During the nineteenth century, foreign exchange brokers made active markets for exchange of various currencies against the Pound Sterling. This virtually gave the Pound Sterling the role of a benchmark of value, similar to gold. In the twentieth century the role of benchmark currency moved to the US Dollar.

How are the foreign exchange rates determined?

To understand the basis of price determination in foreign exchange markets, we must first explore the basis of currency itself. The currency of a nation is a commodity that serves as a store of value and also a means of transferring value to facilitate trade.

As I have mentioned previously, in the last paragraph, till the nineteenth century there was the gold standard but now it is non existent, hence the big question: What is the value of a dollar in comparison to the Euro or the value of a British Pound in comparison to the Japanese Yen?

The answer to this question, although a very debatable one, is that the value of a currency is equal to what one can buy with it. Thus the value of a currency is relative rather than an absolute concept. This value is implicit in the price of goods and services in a country.

An example of how exchange rates are determined is: Imagine that pizza is the most important food in the world. The current price of a slice of pizza in the US is $1.40, and in the UK is 1.65 Pounds. Comparing the two prices we can arrive at the exchange rate between these currencies as US Dollar to British Pound = 1.65 / 1.40 = 1.17

Another way to determine exchange rates is using the purchasing power parity of a currency. Purchasing power parity (PPP) is an economic theory that states that the rate of exchange of one currency to another should be equal to the inverse ratio of the prices for representative goods in the two currencies.

Purchasing power parity implies that the equilibrium exchange rate is given by:
Exchange rate = Price in terms currency / Price in base currency

Although this theory is logical, in real life it is impossible to define the representative goods and services as their quality vary from one nation to another. Still analysts study a large diversity of representative goods to estimate the PPP levels of various currencies (against the USD). When an exchange rate is higher than the corresponding PPP rate, the currency is said to be undervalued and when the exchange rate is lower than the corresponding PPP rate the currency is said to be overvalued

An example of this would be the Big Mac index, which compares the prices of McDonald's Big Mac hamburgers in several countries. *The Economist* publication of London in the U.K. constructed this index and today it can be regarded as good a PPP indicator as any. Some of the properties that make the Big Mac a suitable benchmark for comparison is its availability and consistency across most countries in the world. Moreover, it is an unregulated commodity whose prices are relatively stable.

Shortcomings of the purchasing power parity

Although the purchasing power parity theory is pretty easy to follow and agree to, it makes several assumptions that weaken its influence on the exchange rate determination process. Some of these shortcomings are: Presence of tariffs and quotas, presence of exchange controls, barriers to free trade such as standards and regulations, and lack of a perfect representative of goods.

Despite these shortcomings, PPP does indicate the "equilibrium" rates of exchange. The spot exchange rates may deviate from these levels in the short term.

Demand and supply factors in currency markets

In the short term, currency exchange rates are strongly influenced by capital flows as investors shift funds between countries in search of the most attractive investments. A large inflow of funds increases the demand for a given currency such as the dollar and strengthens it. While a large outflow of funds increases the supply of the currency such as the dollar and hence weakens it.

A descriptive example of this is the Asian currency crisis of 1997-98 when most of the southeast Asian stock markets lost 20% - 50% of their value. Given a further 30% to 80% devaluation of local currencies over the same period, the losses for international investors were enormous.

Young investors get nervous as stock prices fall

by Grace Shim
January 10, 2001
Knight-Ridder Tribune

Watching the value of your portfolio drop by half is never easy the first time around. Many investors whose stock market experience covers less than five years, one of the best five-year periods in stock market history, are smarting from a painful lesson in market correction.

Last year was volatile. The Nasdaq, heavy with technology stocks, by mid-December had taken a 50 percent dive from its March peak. Creighton University economics professor Ernie Goss has noticed that among his students "a lot are very discouraged with the market."

Younger people are more likely to be growth investors and growth stocks had a tough time during the latter part of 2000, he explained. Young people, Goss said, likely haven't known anything but economic growth. "If you graduated after March 1991, you haven't seen a recession," he said. "You haven't seen significant unemployment." The rise in stock market values beginning in late 1994 was spectacular: a climb of more than 175 percent in the Dow Jones industrial average, 350 percent in the Nasdaq and more than 200 percent in the Standard & Poor's 500. Those kinds of returns heightened expectations. Cella Quinn, an Omaha financial adviser, cites a recent Gallup poll that said investors younger than 40 expect returns to average 21.9 percent a year. The reality, she said, is that the average annual stock market return from 1928 to 1999 was 10.5 percent. And since 1928, a 10-year average annual return of 21.9 percent has never occurred. The highest one-year gain was 19 percent.

"There's only been five times since 1928 that the stock market returns have been over 19 percent on a 10-year average annual return," she said. Chris Hastings, of American Express Financial Advisors in Omaha, said the combination of a hot market and the promotion of financial products pushed young people with little or no experience to invest, many of them around the time the Nasdaq peaked. "They're buying tech stocks, not being pleased with 10 to 15 percent returns," he said. "The biggest thing for me is helping people under 30 understand the returns of 30-40-50 percent that we've seen over the last two years are not the most realistic expectations."

"The concern I've seen is the emotional experience of seeing your account go down 50 percent for the year," he said. "A lot of people who have recently invested have not seen that happen before."

Take Sam Saad, a first-year law student at Creighton University. He started investing in 1996, buying Worldcom stock at age 19. Last year, he watched his portfolio, composed largely of technology stocks, drop 50 percent.

Saad said that he picked stocks through research and by watching the cable financial channel, CNBC. With his parents' and broker's help, Saad picked different technology stocks that he considered popular. It's been crazy," he said. "It will be tougher to pay for school. But, he added, "I don't worry about it that much." Some younger investors say the market has deterred them from investing in technology stocks for a while; some have cashed out. Others say they try not to pay much attention to their statements or to the news.

Many more say they are just waiting it out — for the long term. Hastings, the financial adviser with American Express, said he's seen a lot of self-investors now seeking professional advice. He said that he's also seen that about 85 percent of younger investors' goals are toward long-term investing.

Take University of Nebraska-Lincoln graduate student Ryan Hayes, 25, for instance. He's had the joy of watching his initial investment turn into $65,000, thanks to the technology stock boom. And he's felt the pain of his portfolio dwindling to $41,000 due to the technology stock bust. "I got so killed over a couple months," Hayes said. "I've tried to not hit that panic button. "It's easy to get caught up watching it every day," he said.

"My home page with Excite has my portfolio. It has been incredibly painful watching it." Hayes started investing in high school and opened a managed account with Salomon Smith Barney four or five years ago, a period in which he has seen 15 percent to 18 percent returns. "It was fun the last few years," he said. Now, he tries "not to watch it." "I know a lot of people who are pretty shocked and who converted their investments into cash."

Hayes said he leaves the decision making to his portfolio manager, who recently has diversified Hayes' holdings away from a heavy load of technology stocks. After watching his portfolio drop 40 percent in four to five months, Ralston resident Corey Krause, 25, is going to take his profits — if he can get some.

"What I've taken from the past couple of months is if my stock goes up 50 percent, sell and go to something else," he said. Krause admits he looks for "high-risk, volatile health care and pharmaceutical stocks" because he wants a higher return than the 10 percent average. "I'm shooting for hopefully 15 percent," he said. "Being young, I was looking at 30 years in the future and did huge risk to moderate risk to hopefully get a higher net return."

When Krause started investing about two years ago, taking investing in his own hands, he watched the financial cable channels, talked with other investors and did research on the companies. "The first year, I did pretty good," he said. "At one point, I doubled." But it didn't last. Krause said one of his stocks slid 48 percent. CM+RT"I wasn't surprised that it went down," Krause said. "I'm surprised to see how much it's gone down." -RTKrause said that he's "coping fine because I guess I understand the market is going to go up and down." "To me, it's kind of fun," he said. "It's the highest form of gambling. It's exciting to do it on your own."

Allison Walters, 23, human resources analyst for the Federal Reserve Bank in Omaha, took the opposite approach — a more conservative one. Upon starting her new job in June 1999, Walters started a Roth IRA — a tax-deferred retirement account — and picked a mutual fund in which to invest her savings. Though new to investing, she made sure to stay away from technology stocks because "they were pretty unstable."

Last year, Walters changed her mutual fund to a more conservative one, but overall, "I rode it out a little bit." She said that early this year, she plans to talk with financial advisors, intends to pursue technology stocks and will start a 401K retirement plan. "I think my generation, we need to plan for the future," she said. "Then there's the age-old question — do we have the money? And I think we do."

"Putting $20, $30 away a month helps."

Here are the current exchange rates for some selected currencies to one U.S. dollar:

Euro: *1.06*
Deutsche Mark: *2.07*
Japanese Yen: *118.11*
British Pound: *0.68*
French Franc: *6.95*

From Wall St. we have here the closing market figures for 01/18/2001:

DJIA:
10678.28
up 93.94 (0.89%)

NASDAQ:
2768.49
up 85.71 (3.19%)

S&P 500:
1347.97
up 18.50 (1.39%)

BOND:
111 5/32
up 9/16 (5.48%)