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Note on Understanding Exchange Rates

In today's global economy, exchange rates have a significant influence on a firm's competitive position. It is critical, therefore, that business managers understand exchange rates so that they can make informed decisions and manage risks, ultimately in order to better compete in the marketplace. Exchange rates, however, are poorly understood. Indeed, managers often don't know what they are, how to calculate them, or how they impact the firm. This note provides definitional information and a basic analytical tool set with which to understand exchange rates and their effect on business performance. The note covers three broad topics:

- **Terminology**: What are exchange rates?; Quotations; Real vs. nominal exchange rates;
- **Analytics**: Calculating exchange rates; Measuring appreciation and depreciation; Calculating real exchange rates;
- **Examples**: How exchange rate shifts affect a firm's competitive position.

Exchange rate determination (i.e. the factors that determine exchange rates) is a distinct topic that is outside the scope of this note and is covered elsewhere.

Terminology

Definition

An exchange rate is simply the price of one currency in terms of another currency. For example, on February 4, 2008, the U.S. dollar (USD) could purchase 1.747 Brazilian reals (BRL), 7.197 Chinese renminbi (RMB), or 9,213 Indonesian rupees. Table 1 lists a sample of exchange rates as of February 4, 2008:

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