

CURRENCY EXCHANGE RATES

Reading time ~ 2 min.

Which currency exchange rates should we use when comparing wealth or incomes across countries with different currencies? Although current (or actual) currency exchange rates can be volatile, PPP (Purchasing Power Parity) exchange rates can be completely misleading.

As shown in Table 1, PPP exchange rates in emerging markets (EM) are always undervalued, on average by more than 100%! When something is consistently "undervalued" for decades, by more than 100%, the obvious conclusion must be that the valuation model is wrong.

Table 1: The Difference Between PPP and Current Exchange Rates: EM

Country	2000	2002	2004	2006	2008	2010	2012	2014	2016	2018	2020	Country Average
Argentina	35%	232%	183%	151%	91%	73%	41%	48%	59%	100%	141%	99%
Armenia	320%	341%	286%	197%	107%	133%	154%	152%	198%	209%	213%	208%
Brazil	142%	237%	187%	98%	51%	27%	22%	30%	64%	66%	125%	92%
Chile	123%	176%	126%	73%	70%	48%	40%	55%	65%	56%	84%	84%
China	204%	207%	192%	176%	118%	104%	77%	63%	67%	56%	63%	120%
Colombia	168%	195%	183%	142%	86%	69%	49%	64%	138%	120%	164%	125%
Czechia	181%	130%	79%	66%	24%	40%	47%	63%	94%	75%	79%	79%
Hungary	208%	143%	81%	87%	45%	67%	79%	80%	113%	97%	116%	99%
India	318%	340%	291%	274%	227%	203%	231%	232%	238%	224%	238%	254%
Indonesia	450%	422%	358%	282%	225%	172%	163%	194%	195%	199%	205%	261%
Malaysia	198%	205%	191%	173%	125%	127%	112%	117%	160%	148%	169%	158%
Mexico	79%	70%	85%	68%	60%	71%	68%	65%	121%	112%	129%	83%
Nigeria	286%	254%	223%	129%	86%	105%	81%	71%	141%	145%	141%	152%
Peru	163%	171%	153%	132%	106%	89%	65%	72%	94%	89%	92%	112%
Philippines	221%	253%	267%	221%	162%	154%	134%	135%	151%	168%	153%	185%
Poland	164%	142%	115%	85%	40%	69%	81%	79%	128%	110%	120%	102%
Russia	453%	375%	234%	144%	74%	86%	58%	83%	177%	140%	178%	176%
South Africa	154%	232%	89%	88%	102%	60%	61%	95%	139%	103%	142%	111%
South Korea	37%	48%	33%	17%	33%	34%	32%	21%	35%	29%	42%	33%
Thailand	264%	290%	261%	227%	180%	160%	154%	160%	177%	154%	153%	199%
Turkey	155%	204%	117%	97%	58%	65%	76%	98%	143%	209%	273%	134%
Vietnam	400%	428%	353%	313%	227%	220%	191%	183%	200%	201%	205%	266%
Average	215%	232%	186%	147%	104%	99%	92%	98%	132%	128%	147%	142%

Source: IMF

As shown in Table 2, for developed economies PPP exchange rates are not far from actual exchange rates. Ironically, PPP exchange rates are rarely used for developed economies. Most frequently current exchange rates are used for developed countries and PPP rates for EM economies.

Table 2: The Difference Between PPP and Current Exchange Rates: DM

Country	2000	2002	2004	2006	2008	2010	2012	2014	2016	2018	2020	Country Average
Australia	40%	45%	5%	-1%	-16%	-26%	-37%	-24%	-7%	-9%	-2%	-3%
Canada	23%	31%	7%	-6%	-14%	-16%	-20%	-10%	10%	8%	13%	2%
Denmark	10%	6%	-19%	-19%	-31%	-26%	-23%	-23%	-5%	-6%	-1%	-13%
Euro Area	29%	24%	-5%	-3%	-17%	-8%	-3%	-4%	19%	14%	18%	5%
Japan	-30%	-13%	-20%	-6%	-11%	-21%	-23%	3%	3%	7%	6%	-8%
New Zealand	58%	53%	6%	10%	-2%	-6%	-17%	-16%	0%	1%	5%	7%
Sweden	-1%	5%	-18%	-15%	-25%	-19%	-22%	-21%	-3%	0%	4%	-10%
Switzerland	7%	1%	-16%	-13%	-25%	-27%	-31%	-29%	-18%	-15%	-16%	-17%
UK	-6%	-4%	-22%	-21%	-22%	-8%	-10%	-13%	7%	10%	13%	-7%
USA	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%
Average	13%	15%	-8%	-7%	-16%	-16%	-19%	-14%	1%	1%	4%	-4%

Source: IMF

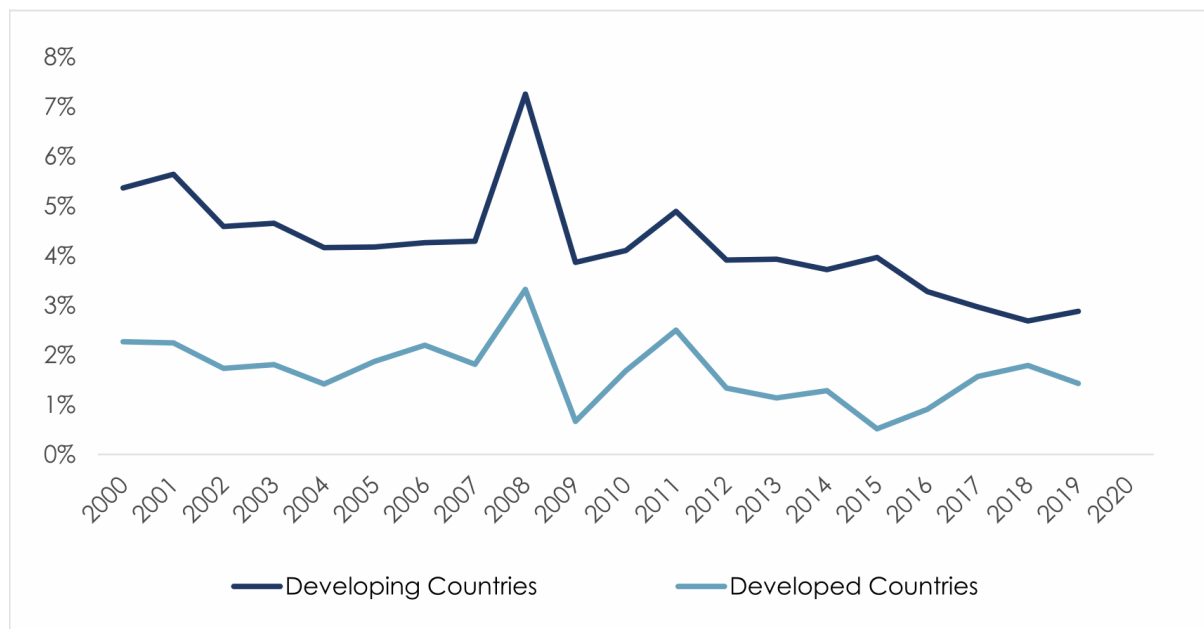


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The fact that almost all EM currencies are constantly undervalued, and by huge amounts, should mean – at least in theory – that EM economies have galloping inflation rates. As shown in Chart 1, inflation has been constantly falling across almost all EM economies, despite “undervalued” exchange rates.

Chart 1: CPI Inflation



Source: World Bank

Conclusion

Be careful with PPP exchange rates in emerging economies. They are often meaningless and are used by those who are trying to artificially inflate the \$US value of certain EM economies. Make it simple and use current exchange rates.

David Tavadian
Founding Partner

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