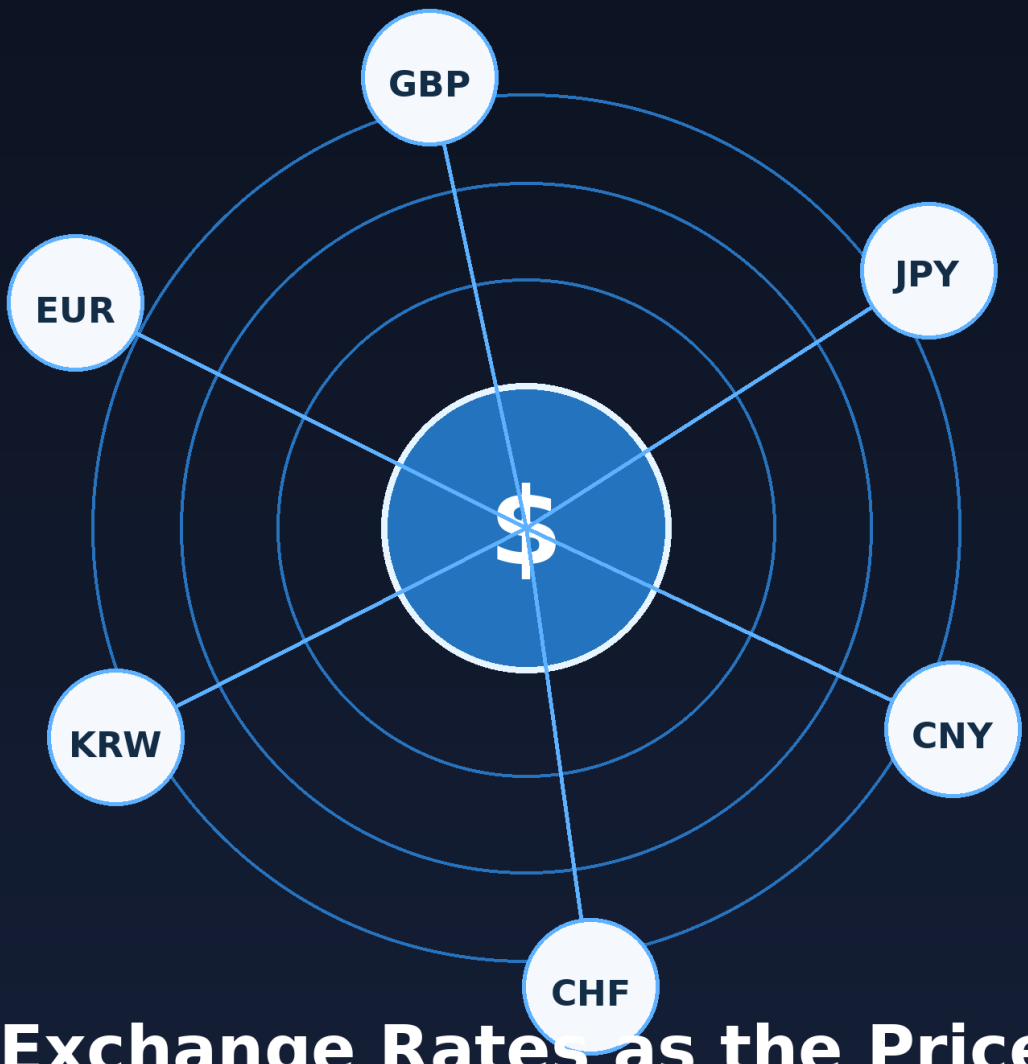

Exchange Rates as the Price of Power

Foreign Exchange Markets, Dollar Hegemony, Capital Flows, and Investment Strategy

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June 2026

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Purpose

This report explains exchange rates not merely as a conversion ratio but as a market price that condenses interest rates, inflation, national credibility, trade structure, capital mobility, central bank power, geopolitical risk, and the hierarchy of the dollar-centered international financial order.

Disclosure

This document is for education and strategic analysis. It is not investment advice, legal advice, tax advice, accounting advice, or a recommendation to buy or sell any currency, security, derivative, or financial product.

Table of Contents

1. Executive thesis: exchange rates as power prices
2. 1. Basic concepts of exchange rates
3. 2. How the FX market is organized
4. 3. Fixed and floating exchange-rate regimes
5. 4. Core determinants of exchange rates
6. 5. Interest rates, inflation, real yields, and carry
7. 6. Trade balances, current accounts, and capital accounts
8. 7. Central bank policy and intervention
9. 8. The U.S. dollar at the center of the global system
10. 9. Currency profiles: KRW, JPY, EUR, CNY, GBP, CHF, and EM FX
11. 10. Appreciation and depreciation: real-world effects
12. 11. Exchange rates and financial crises
13. 12. How individual investors should read FX
14. 13. How companies should manage FX risk
15. 14. Long-term exchange-rate cycles
16. 15. Practical checklist
17. Conclusion
18. Appendix: glossary and source notes

The report uses original conceptual images and diagrams created for this document. Data points cited in source notes are used for context, not for short-term trading signals.

Executive Thesis: Exchange Rates as Power Prices

An exchange rate is the market price of one national balance sheet against another. It reflects not only money but power: the power to tax, borrow, defend property rights, attract capital, control inflation, sustain external deficits, and survive crisis without default or capital flight.

A currency appreciates when the world becomes more willing to hold claims denominated in that currency. A currency depreciates when the world demands a discount to hold it. The discount may arise from lower real yields, inflation risk, weak institutions, foreign-currency debt, political instability, external deficits, or a shortage of liquid reserves.

The most important practical lesson is that exchange rates sit at the intersection of two balance sheets. A household, investor, bank, company, or country must ask: in which currency do I earn, spend, borrow, save, and invest? Currency risk becomes dangerous when cash flows and liabilities are mismatched.

The U.S. dollar is central because it is not merely the currency of the United States. It is the operating currency of a large part of global finance: trade invoices, commodity contracts, bank funding, reserves, Treasury collateral, derivatives margin, and crisis liquidity. In a dollar-centered world, many exchange rates are effectively local currencies priced against dollar liquidity and U.S. interest-rate expectations.

Four strategic claims organize the report:

- **Exchange rates are relative prices:** They compare two monetary regimes, two inflation paths, two interest-rate structures, and two political economies.
- **Nominal FX is not enough:** Real exchange rates matter because inflation can erase the purchasing-power meaning of a nominal move.
- **Dollar strength is systemic:** A stronger dollar can tighten financial conditions worldwide because many borrowers, trade contracts, reserves, and funding markets are dollar-linked.
- **Hedging is balance-sheet management:** The purpose of currency hedging is not to forecast perfectly; it is to prevent currency volatility from destroying a business plan or investment thesis.

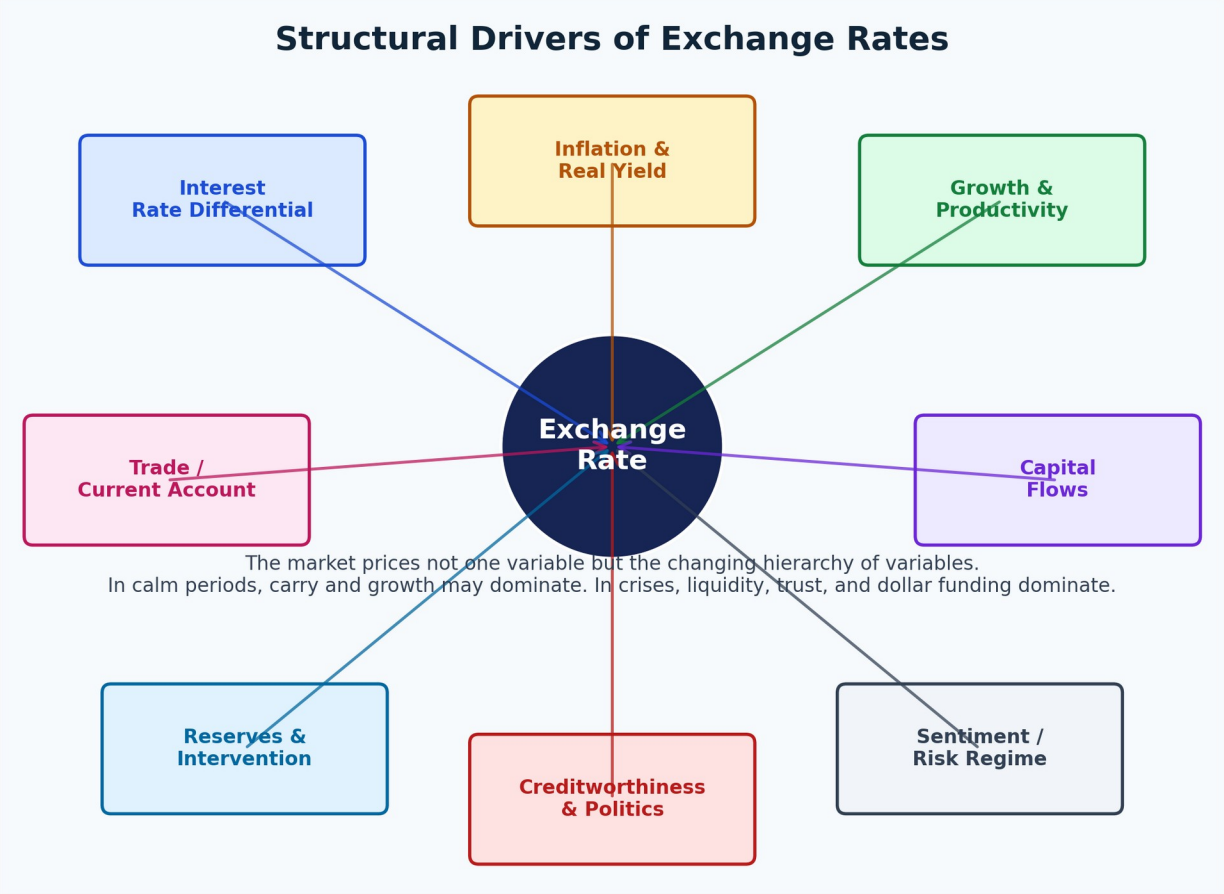

Figure 1. Exchange rates integrate macro fundamentals, policy choices, flows, and confidence.

1. Basic Concepts of Exchange Rates

1.1 Nominal exchange rate

The nominal exchange rate is the quoted price between two currencies. If USD/KRW is 1,350, one U.S. dollar buys 1,350 Korean won. If EUR/USD is 1.10, one euro buys 1.10 U.S. dollars. Nominal exchange rates are what consumers see at banks, brokers, travel kiosks, and trading platforms.

Nominal rates are useful for transactions, but they do not by themselves tell whether a country has become cheaper or more expensive in real economic terms. For that, one must adjust for relative inflation.

1.2 Real exchange rate

The real exchange rate adjusts the nominal exchange rate by the price levels of two economies. It asks whether goods, services, labor, property, and production costs have become more or less expensive after accounting for inflation. A country can have a stable nominal currency but lose competitiveness if domestic inflation is persistently higher than abroad.

A simplified real exchange-rate intuition is:

Real exchange rate = nominal exchange rate x foreign price level / domestic price level

The exact convention changes by quotation method, but the economic meaning is stable: real FX measures purchasing power and competitiveness, not only the screen price.

1.3 Base currency and quote currency

In a currency pair, the base currency is the unit being priced, and the quote currency is the currency used to express the price. In EUR/USD, EUR is the base and USD is the quote. In USD/JPY, USD is the base and JPY is the quote.

This distinction matters because a rising EUR/USD means the euro is appreciating against the dollar, while a rising USD/JPY means the dollar is appreciating against the yen.

1.4 Bid, ask, spread, and conversion costs

The bid is the price at which a dealer is willing to buy the base currency. The ask is the price at which a dealer is willing to sell the base currency. The spread is the difference between the two. In wholesale interbank markets, spreads can be very narrow for liquid pairs. In retail conversion, remittances, credit-card FX, airport kiosks, and small business transfers, total costs may be materially higher because of markups and fees.

- **Market spread:** The visible difference between bid and ask quotes.
- **Dealer or platform markup:** The additional margin embedded by a bank, broker, app, payment provider, or card network.
- **Explicit fees:** Wire fees, transfer charges, custody costs, or account fees.
- **Timing cost:** Slippage between quote time and execution time, especially in volatile markets.
- **Tax and accounting effects:** Realized FX gains and losses may affect taxable income or financial statements.

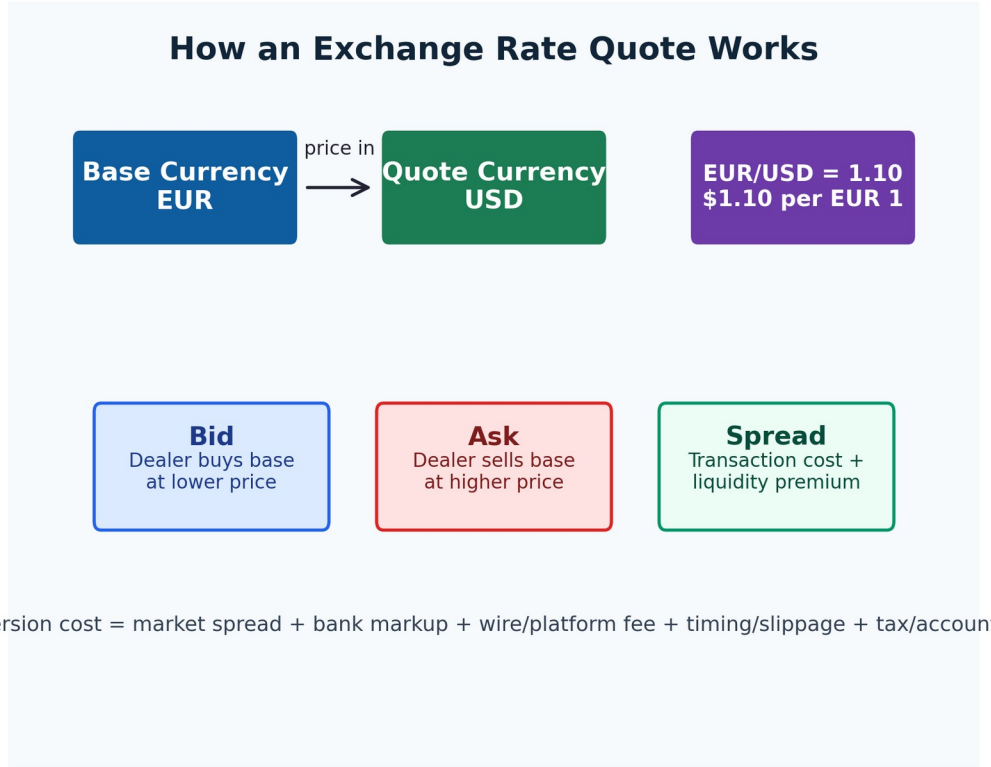

Figure 2. FX quotes translate one monetary unit into another and include visible and hidden transaction costs.

2. How the FX Market Is Organized

Foreign exchange is not a single centralized exchange like the New York Stock Exchange. It is a global over-the-counter network of banks, dealers, brokers, asset managers, hedge funds, central banks, corporations, payment companies, and electronic platforms. Trading moves across time zones: Asia, Europe, London, New York, and back to Asia.

According to the BIS 2025 Triennial Survey, global OTC FX turnover reached about $9.6 trillion per day in April 2025, and the U.S. dollar was on one side of 89.2% of all trades. These figures illustrate why foreign exchange is both a trading market and the plumbing of global commerce and finance. [1]

2.1 Spot, forwards, swaps, options, and settlement

- **Spot FX:** A near-immediate exchange of currencies, commonly settling two business days after trade date for many pairs.
- **Forward FX:** A contract to exchange currencies at a future date at a pre-agreed forward rate.
- **FX swap:** A spot exchange combined with a reverse forward exchange, often used for funding and hedging.
- **Currency option:** The right, but not the obligation, to exchange currencies at a certain rate; useful for asymmetric protection.
- **Cross-currency basis swap:** A more institutional tool that exchanges interest and principal payments in different currencies, often revealing funding stress.

2.2 Liquidity hierarchy

Currency pairs differ radically in liquidity. EUR/USD, USD/JPY, GBP/USD, USD/CHF, USD/CAD, AUD/USD, and major crosses have deep markets. Emerging-market currencies may trade smoothly in calm periods but become illiquid in stress, especially when offshore dollar funding tightens or local policy credibility weakens.

2.3 The difference between transaction FX and balance-sheet FX

Transaction FX is the price you pay to convert money. Balance-sheet FX is the risk that the value of your assets, liabilities, income, or expenses changes because currencies move. A tourist mostly faces transaction FX. A company with dollar debt and local-currency revenue faces balance-sheet FX. A country with foreign-currency liabilities faces systemic FX risk.

3. Fixed and Floating Exchange-Rate Regimes

3.1 Floating exchange rates

A floating exchange-rate system allows the currency to move with supply and demand. The central bank may still intervene or influence the rate through interest-rate policy, liquidity operations, guidance, or reserve management, but it does not promise a fixed parity.

Floating rates act like shock absorbers. If a country faces a negative export shock, depreciation can partially restore competitiveness. But floating can also transmit financial panic if investors suddenly sell local assets, hedge funds short the currency, or domestic residents move savings abroad.

3.2 Fixed exchange rates and pegs

A fixed exchange-rate system promises to keep the currency at or near a target level against another currency or basket. Pegs can reduce uncertainty for trade and investment, but they require credible policy discipline and sufficient reserves. If markets doubt the peg, the central bank may be forced to raise rates, use reserves, impose capital controls, devalue, or abandon the regime.

3.3 The policy trilemma

The classic open-economy trilemma says a country cannot simultaneously have all three: a fixed exchange rate, free capital mobility, and independent monetary policy. It can choose two, but the third becomes constrained. This is why exchange-rate regimes are political choices, not merely technical settings.

3.4 Managed floats

Many currencies operate in the middle: formally flexible but heavily influenced by intervention, reserve accumulation, policy signals, macroprudential controls, or state banking systems. The practical question is not whether a currency is purely fixed or purely floating, but how policy authorities manage the trade-off between competitiveness, inflation, financial stability, and credibility.

4. Core Determinants of Exchange Rates

Exchange rates are multi-causal. At different times, the market emphasizes different variables. A high-yielding currency may strengthen during risk-on periods but collapse in risk-off periods. A current-account surplus currency may weaken if its central bank runs extremely loose policy. A country with strong growth may still depreciate if investors fear inflation, political instability, or foreign-currency debt.

4.1 Interest-rate differentials

Capital tends to seek higher risk-adjusted returns. If one country raises rates while another cuts rates, its currency may attract capital through carry trades and bond inflows. But the word risk-adjusted is crucial: high nominal rates may compensate for inflation, default risk, or devaluation risk rather than signal strength.

4.2 Inflation differentials

A country with persistently higher inflation tends to lose purchasing power. Over long horizons, exchange rates often reflect relative inflation through purchasing-power adjustment. In the short run, however, inflation can have ambiguous effects if it causes the central bank to raise rates aggressively.

4.3 Growth and productivity

Strong growth can support a currency by attracting investment and improving fiscal capacity. Productivity gains are especially powerful because they allow wages, profits, and competitiveness to rise together. But growth driven by credit bubbles, real estate leverage, or commodity booms can become currency-negative when the cycle turns.

4.4 Trade balance and current account

The trade balance measures exports minus imports of goods and services. The current account is broader, including trade, income flows, and transfers. A surplus economy earns foreign currency from the rest of the world; a deficit economy must finance the gap through capital inflows, reserves, borrowing, or currency adjustment.

4.5 Capital account and portfolio flows

In modern markets, capital flows often dominate trade flows. Foreign purchases of stocks, bonds, private equity, real estate, bank deposits, and direct investment can overwhelm trade balances. A country can run a current-account deficit for years if global investors are eager to hold its assets. Conversely, a surplus country can see currency weakness if domestic investors export capital faster than trade surpluses bring it home.

4.6 Foreign exchange reserves

Reserves are the central bank assets - often dollars, euros, yen, gold, and highly liquid securities - used to stabilize markets, pay external obligations, and maintain confidence. Large reserves do not guarantee stability, but they give authorities time and credibility. Low reserves make a country vulnerable to sudden stops, import shortages, and speculative attacks.

4.7 Sovereign creditworthiness and political stability

Currencies price trust. Investors ask whether a state can tax, borrow, regulate, enforce contracts, avoid arbitrary confiscation, maintain central bank credibility, and manage political transitions. Currency depreciation is often the market language of declining trust.

4.8 Central bank intervention and market sentiment

Central banks can intervene by buying or selling currencies, adjusting interest rates, using swap lines, imposing macroprudential rules, or guiding expectations. Yet intervention works best when it aligns with fundamentals. If markets believe policy is fighting an unsustainable trend, intervention may slow depreciation but not reverse it.

5. Interest Rates, Inflation, Real Yields, and Carry

A currency is partly the price of interest rates. Investors compare expected returns across currencies after adjusting for inflation, volatility, liquidity, taxation, hedging cost, and default risk.

5.1 Nominal rates vs real rates

Nominal rates are the headline interest rates. Real rates subtract expected inflation. A currency with a 10% nominal yield and 12% inflation may be less attractive than a currency with a 4% yield and 2% inflation. Real yield and credibility matter more than yield alone.

5.2 Carry trade

A carry trade borrows in a low-yielding currency and invests in a higher-yielding currency. It works when exchange rates remain stable or move in favor of the high-yield currency. It fails when volatility spikes and investors rush to repay funding currencies, causing abrupt reversals.

5.3 Covered interest parity and hedged returns

For institutional investors, the forward rate embeds interest-rate differentials. A foreign bond with a higher yield may not be attractive after hedging the currency back into the investor's home currency. Hedged returns often matter more than unhedged headline yields for insurers, pensions, banks, and conservative asset managers.

5.4 Policy surprise

Exchange rates often move less on the level of rates and more on changes in expected future rates. A currency may strengthen if the central bank is expected to be more hawkish than previously believed, and weaken if the market prices earlier or deeper rate cuts.

6. Trade Balances, Current Accounts, and Capital Accounts

The balance of payments is the national accounting framework behind exchange rates. A country's currency is continuously influenced by the need to pay for imports, receive export revenue, distribute investment income, borrow abroad, repay debt, and attract or export capital.

6.1 Exporters and importers

Exporters often benefit from depreciation because foreign buyers can purchase local goods more cheaply, and foreign revenue converts into more local currency. Importers often suffer because imported inputs, energy, machinery, technology, and consumer goods become more expensive.

6.2 Structural current-account positions

A surplus country may have a currency supported by recurring foreign-currency income. But surplus does not guarantee appreciation if the country recycles savings abroad, runs very low interest rates, or faces domestic investment weakness. A deficit country may have a strong currency if it issues the world's reserve asset, attracts global capital, or offers superior returns.

6.3 Capital flows can dominate goods flows

In a financialized world, portfolio flows can move faster and larger than trade flows. A pension fund allocation, hedge fund carry trade, sovereign wealth rebalancing, bank funding squeeze, or ETF flow can move a currency before trade data changes.

7. Central Bank Policy and Intervention

Central banks shape exchange rates directly and indirectly. Directly, they may buy or sell currencies. Indirectly, they control the monetary base, short-term rates, liquidity operations, bank reserves, regulatory conditions, and inflation expectations.

7.1 Interest-rate defense

A central bank can defend a currency by raising rates, making it more expensive to short the currency and more attractive to hold local assets. But high rates can also damage growth, banks, real estate, public finances, and political stability.

7.2 Reserve intervention

When a currency weakens, a central bank may sell foreign reserves and buy local currency. This can reduce disorderly depreciation, but it consumes reserves. If investors see reserves falling quickly, intervention may amplify panic.

7.3 Sterilized vs unsterilized intervention

Sterilized intervention offsets the domestic liquidity impact of FX intervention; unsterilized intervention allows the money supply effect to pass through. The distinction matters because FX intervention is also monetary policy.

7.4 Swap lines and crisis liquidity

Central bank swap lines can provide foreign-currency liquidity during stress. Dollar swap lines are especially important because global banks and corporations often need dollars even outside the United States. Access to crisis dollar liquidity is itself a form of geopolitical and financial power.

8. The U.S. Dollar at the Center of the Global System

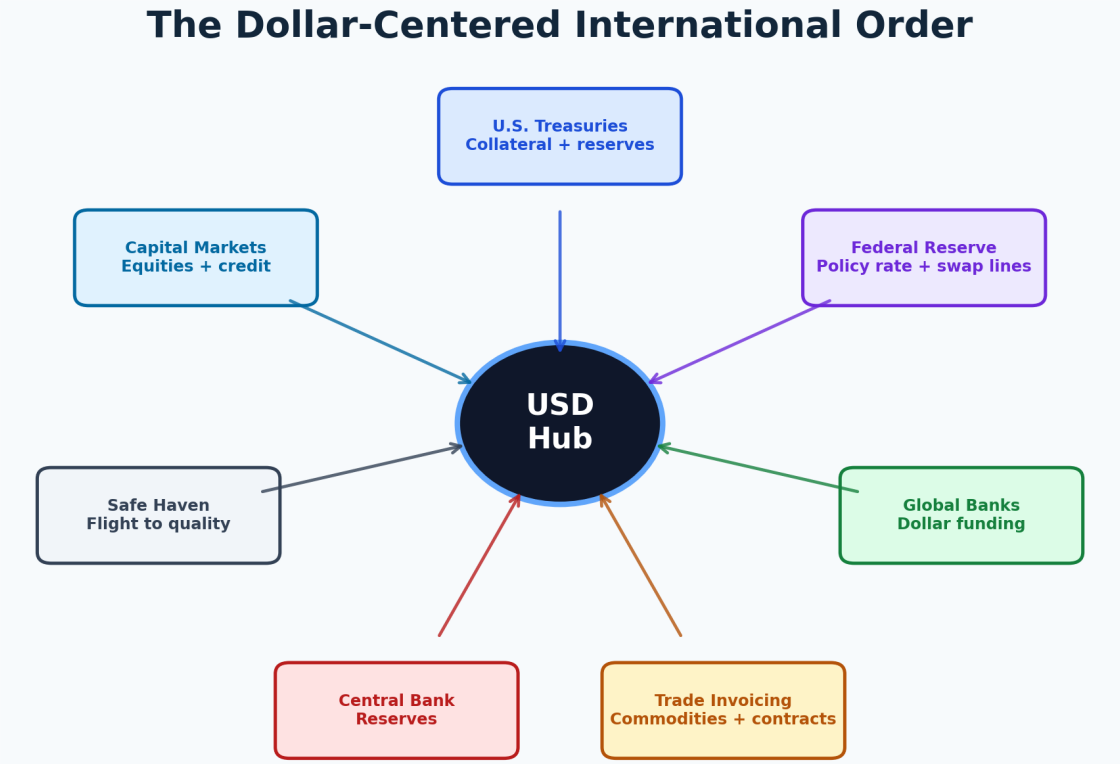

Figure 3. The dollar is a currency, a funding system, a reserve asset, a collateral network, and a crisis shelter.

The U.S. dollar stands at the center of exchange rates because the world uses it for trade, reserves, banking, securities issuance, derivatives, commodities, and crisis liquidity. The dollar is not only a national currency; it is the dominant international balance-sheet unit.

8.1 Dollar Index

The U.S. Dollar Index is a commonly watched measure of the dollar against a basket of major currencies. It is useful for seeing broad dollar direction, but it is not the whole dollar system. Many emerging-market currencies, commodities, offshore funding markets, and global risk indicators can reveal dollar stress before or beyond the index itself.

8.2 U.S. Treasuries

U.S. Treasury securities are central because they combine scale, liquidity, collateral utility, and legal-institutional depth. Reserve managers, banks, insurers, asset managers, hedge funds, and foreign official institutions use Treasuries as safe assets, collateral, liquidity buffers, and benchmarks. The U.S. Treasury TIC system tracks foreign holdings and transactions in U.S. securities, reflecting the link between capital flows and the dollar. [4]

8.3 Federal Reserve rates

Fed policy sets the anchor for dollar short rates. When U.S. rates rise relative to other countries, dollar assets may become more attractive, dollar funding may become more expensive, and global financial conditions may tighten. When U.S. rates fall, global risk appetite may improve, but the dollar can weaken if yield support declines.

8.4 Global capital flows

The dollar attracts global capital because U.S. markets offer depth across Treasuries, agency securities, corporate bonds, equities, private assets, venture capital, derivatives, and banking. Foreign demand for U.S. securities supports the dollar; fear about U.S. fiscal sustainability or institutional credibility can weaken it.

8.5 Safe-haven demand

In crises, investors often seek dollars because debts, collateral calls, trade finance, and reserve needs are dollar-linked. This can produce a paradox: a crisis that begins in the United States may still create global demand for dollars if the world needs dollar liquidity to reduce leverage.

8.6 Emerging-market currency crises

Many emerging-market crises are partly dollar crises. If a country borrows in dollars but earns in local currency, depreciation increases the local-currency value of debt. This can trigger a negative loop: weaker currency, higher debt burden, capital flight, reserve loss, higher rates, recession, weaker fiscal position, and further depreciation.

Institutional context:

- **BIS FX data:** The 2025 survey reported about $9.6 trillion in daily OTC FX turnover and the dollar on one side of 89.2% of trades. [1]
- **Federal Reserve research:** The Fed’s 2025 analysis reported the dollar at 58% of disclosed global official foreign reserves in 2024, far ahead of the euro, yen, pound, and renminbi. [2]
- **Federal Reserve/NY Fed framing:** Official conference materials describe the dollar’s preeminent role in international investment, funding, payments, trade transactions, and reserves. [3]

9. Currency Profiles: KRW, JPY, EUR, CNY, GBP, CHF, and Emerging-Market FX

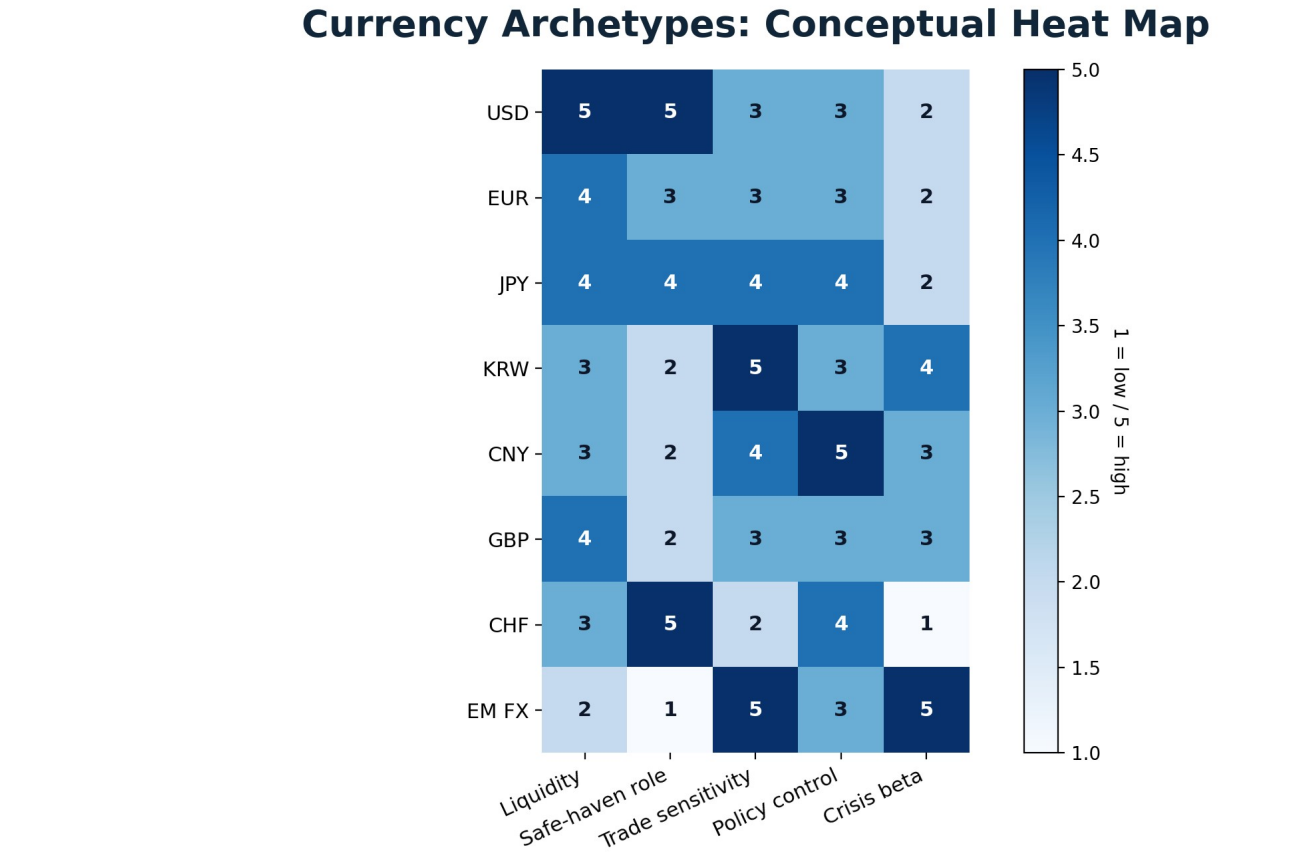

Figure 4. Different currencies represent different combinations of liquidity, policy credibility, trade exposure, and crisis behavior.

Currencies are not generic. Each major currency expresses a specific national or regional structure: industrial composition, external balance, savings behavior, central bank doctrine, geopolitical position, and market depth.

Korean won (KRW)

An open, trade-sensitive, technology-cycle currency. KRW often reflects global semiconductor demand, Korean export momentum, foreign equity flows, oil import costs, China/Asia sentiment, and dollar liquidity. It can be highly sensitive to risk-off episodes because Korea is deeply integrated into global manufacturing and capital markets.

Japanese yen (JPY)

A major funding and safe-haven currency with a unique relationship to low rates, carry trades, domestic savings, and Bank of Japan policy. Yen weakness often reflects rate differentials and carry; yen strength can emerge when global leverage unwinds.

Euro (EUR)

The currency of a large monetary union without a single fiscal sovereign. EUR reflects ECB policy, German/European industrial competitiveness, energy terms of trade, intra-European politics, banking stability, and the euro area's external surplus or deficit dynamics.

Chinese yuan / renminbi (CNY/CNH)

A managed currency shaped by China's capital controls, trade surplus, industrial policy, state banking system, PBOC guidance, geopolitical risk, and the distinction between onshore CNY and offshore CNH markets. It is important globally but not freely convertible in the same way as USD, EUR, or JPY.

British pound (GBP)

A historically important financial-center currency, sensitive to UK inflation, Bank of England policy, fiscal credibility, current-account financing, London capital-market flows, and political risk.

Swiss franc (CHF)

A classic safe-haven currency supported by institutional credibility, low inflation reputation, current-account strength, wealth management, and political stability. The Swiss National Bank may intervene when appreciation becomes excessive.

Emerging-market currencies

A broad category ranging from liquid and credible to fragile and crisis-prone. EM FX tends to be more sensitive to dollar rates, commodity prices, external debt, reserves, political stability, and global risk appetite.

Currency comparison table

Currency	Main support	Main vulnerability	Typical beneficiaries when weak	Typical stress signal
USD	Treasury market, Fed, liquidity, global funding	Fiscal/institutional confidence, valuation, policy surprises	U.S. multinationals with foreign earnings translation may suffer; importers benefit when strong	Dollar funding stress, DXY surge, EM selloff
KRW	Exports, semiconductors, foreign equity inflow	Risk-off, oil import costs, China/tech cycle	Exporters; holders of USD assets in KRW terms	KRW weakness with equity outflows and higher credit spreads
JPY	External assets, safe-haven behavior, funding role	Low yields, carry trades, energy import costs	Japanese exporters, foreign asset holders	Rapid yen decline plus intervention rhetoric
EUR	Large economy, ECB credibility, external sector	Fragmented fiscal politics, energy shocks, banking stress	Eurozone exporters	Peripheral spreads widen, EUR weakens
CNY/CNH	Trade surplus, state management, reserves	Capital outflow pressure, property/credit cycle, controls	Chinese exporters	CNH weakness vs CNY, reserve pressure, outflow controls
GBP	London finance, flexible economy, BoE credibility	External financing, political/fiscal shocks	UK exporters, foreign earners	Gilt stress, current-account financing concern
CHF	Safe haven, low inflation, institutions	Overvaluation, intervention risk	Swiss importers suffer less; exporters face pressure	SNB intervention, negative carry deterrent
EM FX	Commodity exports, high carry, growth	Dollar debt, reserve scarcity, politics	Exporters and commodity producers	FX reserve loss, CDS spreads, capital controls

10. Appreciation and Depreciation: Real-World Effects

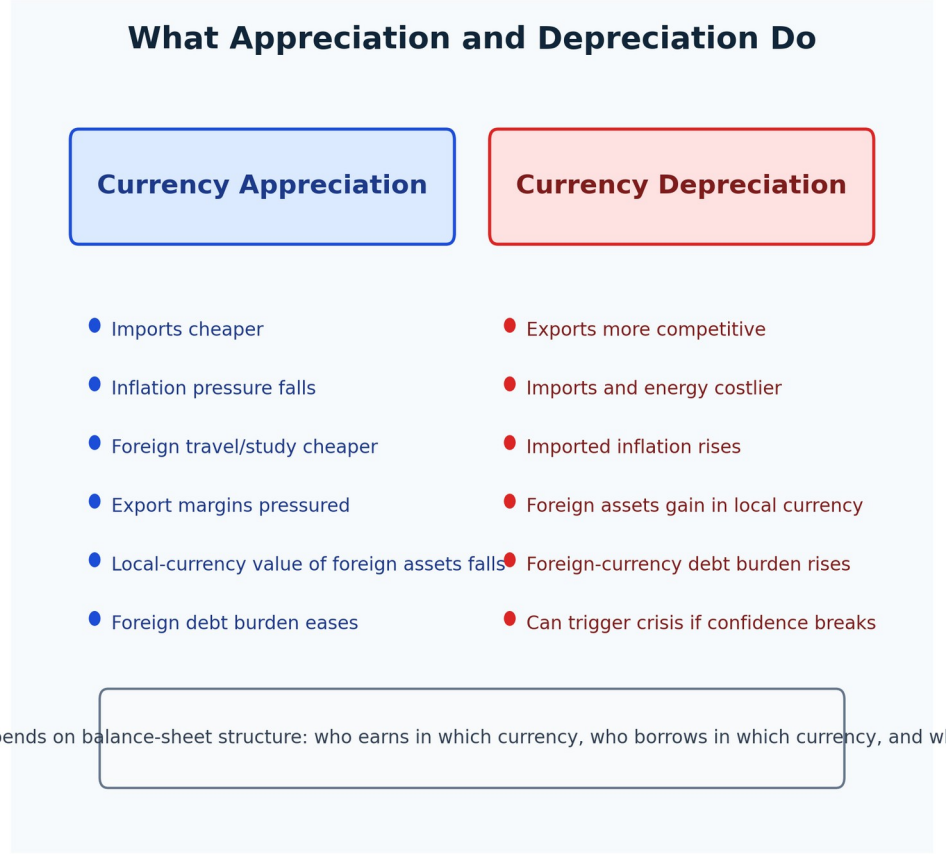

Figure 5. Exchange-rate effects depend on who earns, spends, borrows, and invests in each currency.

Currency appreciation means a currency buys more foreign currency. Currency depreciation means it buys less foreign currency. The effects are not universally good or bad; they redistribute income, costs, and balance-sheet value.

10.1 Exporters

Depreciation can make exports more competitive and increase local-currency revenue from foreign sales. But if exporters import components, use foreign technology, or borrow in foreign currency, depreciation can also raise costs. The net effect depends on supply-chain structure and hedging policy.

10.2 Importers and consumers

Depreciation raises the local-currency cost of imports, energy, raw materials, food, technology, and travel. This can feed inflation. Appreciation lowers import costs and can reduce inflation pressure, but it can also hurt domestic producers competing against cheaper imports.

10.3 Overseas travel and international students

A stronger home currency makes foreign tuition, rent, travel, and living costs cheaper. A weaker home currency raises the burden. Families funding education abroad are effectively short the foreign currency of the destination country.

10.4 Stock markets

Exchange rates affect equities through earnings translation, export competitiveness, import costs, foreign investor flows, discount rates, and risk sentiment. A weaker local currency can support exporters but scare foreign investors if depreciation signals macro instability.

10.5 Bond markets

Foreign investors in local bonds care about total return in their own currency. A high coupon can be wiped out by depreciation. If currency weakness raises inflation expectations, bond yields may rise and prices may fall. For governments and corporations with foreign-currency debt, depreciation increases debt burdens.

10.6 Real estate

Currency moves influence cross-border property investment. A weaker local currency can make domestic property cheaper to foreign buyers but can raise construction costs if materials and financing are imported or dollar-linked. In crisis, FX weakness can also reduce local purchasing power and credit availability.

10.7 Commodities

Many commodities are priced in dollars. A stronger dollar often tightens global purchasing power for commodity importers and can weigh on commodity prices in dollar terms. For commodity exporters, currency depreciation can offset some price weakness by raising local-currency revenue.

10.8 Corporate earnings and national debt

Multinational earnings translation depends on reporting currency. Foreign-currency debt becomes more expensive when the borrower’s home currency depreciates. Sovereigns that issue debt in their own currency have more flexibility than those dependent on foreign-currency borrowing.

11. Exchange Rates and Financial Crises

Currency crises occur when confidence in a currency, regime, or national balance sheet breaks. They often combine several elements: external deficits, short-term foreign-currency debt, inadequate reserves, weak banks, political uncertainty, inflation, and a central bank that lacks credibility or sufficient tools.

11.1 The crisis loop

19. Investors doubt the currency or policy regime.
20. Capital leaves; the currency depreciates.

21. Foreign-currency debt becomes more expensive in local-currency terms.
22. Banks, corporations, or the government face balance-sheet stress.
23. The central bank raises rates or spends reserves to defend the currency.
24. Growth weakens; fiscal and political stress rise.
25. Confidence falls further unless credible adjustment arrives.

11.2 Why foreign-currency debt is dangerous

A country that borrows in dollars but earns in local currency is exposed to a currency mismatch. When the local currency depreciates, debt-service costs rise precisely when domestic conditions often deteriorate. This is why foreign-currency debt is a central vulnerability in emerging-market crises.

11.3 Crisis indicators

- Rapid reserve decline.
- Widening sovereign credit spreads or CDS spreads.
- Large current-account deficit financed by short-term capital inflows.
- High foreign-currency debt relative to exports or reserves.
- Sharp divergence between official and parallel exchange rates.
- Rising inflation with delayed or inconsistent central bank response.
- Bank deposit dollarization or domestic capital flight.
- Political breakdown around fiscal or monetary policy.

12. How Individual Investors Should Read Exchange Rates

Individual investors should not treat FX as a casino ticker. They should treat it as part of their personal balance sheet. The practical issue is currency exposure: where income is earned, where expenses are paid, where assets are held, and where liabilities are owed.

12.1 Start with currency exposure, not forecasts

A Korean resident holding U.S. stocks is long U.S. assets and long USD/KRW if the investment is unhedged. A U.S. resident planning to buy property in Japan has future yen exposure. An international student’s family has a foreign-currency liability. The first task is exposure mapping.

12.2 Dollar-denominated assets

Dollar assets can diversify local-currency risk and provide access to the deepest capital markets. But a dollar asset can lose value in local-currency terms if the dollar depreciates. Investors must separate asset risk from currency risk.

12.3 Foreign-currency deposits

Foreign-currency deposits can be useful for known future expenses, diversification, or crisis liquidity. Their weakness is opportunity cost: cash yields may be lower than securities, and inflation can erode purchasing power. Bank counterparty and deposit insurance rules also matter.

12.4 Overseas stocks

Overseas stocks combine equity risk and currency risk. A foreign market can rise in local currency but deliver lower returns after home-currency appreciation. Conversely, a flat foreign market can produce gains if the foreign currency appreciates.

12.5 Hedged vs unhedged investing

Currency-hedged products reduce FX volatility but add hedging cost and may remove diversification benefits. Unhedged products preserve currency diversification but can increase volatility. The right choice depends on time horizon, liability currency, risk tolerance, and the role of the asset in the portfolio.

12.6 Personal investor rules

- **Do not speculate before mapping exposure:** Know your natural long and short currencies.
- **Match liabilities first:** Tuition, rent, debt, and business payments deserve more hedging than discretionary wealth.
- **Diversify strategic reserves:** Holding some dollar liquidity can be rational for global flexibility, but concentration creates its own risk.
- **Watch real rates, not only nominal rates:** High-yield currencies can still depreciate if inflation and credibility are weak.
- **Respect crisis liquidity:** The ability to access cash in the right currency during stress is often more valuable than small yield pickup.

13. How Companies Should Manage FX Risk

For companies, FX is not merely a treasury issue. It affects pricing, sourcing, debt policy, procurement, sales contracts, accounting, margins, tax planning, and strategic competition.

13.1 Identify three exposures

- **Transaction exposure:** Contracted receivables and payables in foreign currencies.
- **Translation exposure:** Accounting impact when foreign subsidiaries are consolidated into the parent company’s reporting currency.
- **Economic exposure:** The long-term impact of exchange rates on competitiveness, demand, costs, and market share.

13.2 Natural hedging

The strongest hedge is often operational: matching revenue and costs in the same currency, borrowing in the currency of cash flows, sourcing locally, pricing with FX adjustment clauses, or diversifying production footprints. Financial derivatives should complement, not replace, sound operational design.

13.3 Financial hedging tools

- **Forwards:** Lock in a future exchange rate; useful for committed cash flows.
- **Options:** Protect against adverse moves while preserving upside; useful for uncertain exposures.
- **Swaps:** Manage funding and balance-sheet currency mismatches.
- **Netting:** Offset receivables and payables across subsidiaries to reduce gross conversion needs.
- **Policy bands:** Set hedge ratios by certainty, horizon, and risk tolerance rather than by daily forecasts.

13.4 Governance

A company should define who owns FX risk, what exposures may be hedged, which instruments are permitted, how counterparties are selected, what accounting treatment applies, and how hedge effectiveness is measured. FX failure is often a governance failure before it is a market failure.

14. Long-Term Exchange-Rate Cycles

Currencies move in cycles because macro regimes move in cycles: inflation cycles, rate cycles, credit cycles, commodity cycles, fiscal cycles, political cycles, and global risk cycles.

14.1 Dollar cycles

Dollar bull markets often combine relatively high U.S. rates, superior U.S. growth or asset returns, global risk aversion, dollar funding stress, and capital inflows into U.S. securities. Dollar bear markets often combine falling U.S. real rates, stronger non-U.S. growth, improved risk appetite, current-account concerns, or diversification away from U.S. assets.

14.2 Commodity cycles

Commodity exporters can benefit from rising commodity prices, but the currency response depends on fiscal discipline, investment flows, inflation, and whether the commodity boom creates external surpluses or only temporary revenue. Commodity importers often face currency pressure when oil or food prices rise sharply.

14.3 Credit cycles

A credit boom can strengthen a currency by attracting capital, but it can also create future fragility if it funds property speculation, current-account deficits, or foreign-currency liabilities. Currency crises often begin after periods of apparent stability.

14.4 Political and geopolitical cycles

Sanctions, wars, tariffs, capital controls, reserve freezes, alliance structures, and institutional credibility can all change currency demand. FX markets price not only economics but jurisdictional trust.

15. Practical Checklist

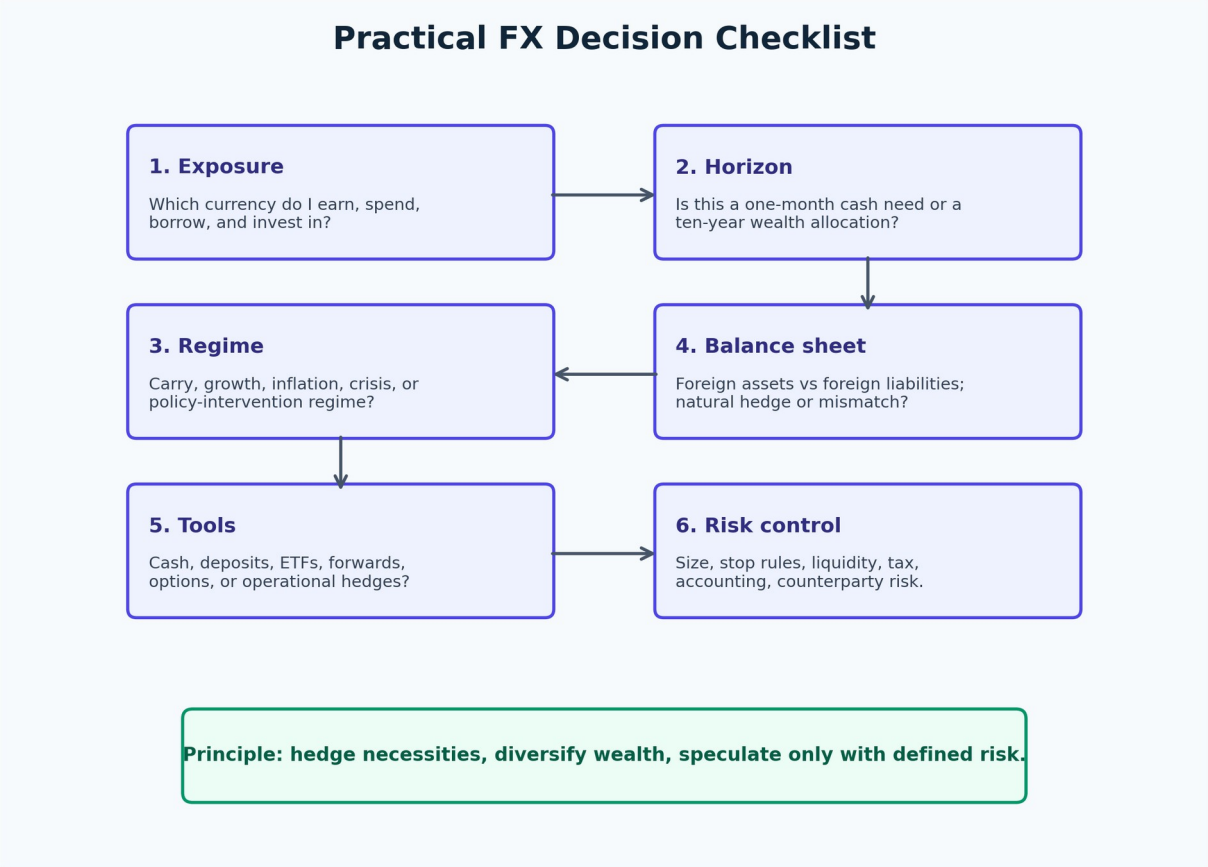

Figure 6. A practical framework for investors, households, and companies evaluating currency exposure.

15.1 For an individual investor

26. List income currencies, spending currencies, asset currencies, and liability currencies.
27. Separate known future needs from speculative desires.
28. For known foreign-currency needs within 12 to 24 months, consider staged conversion or hedging rather than a one-time bet.
29. For long-term wealth, diversify currencies through assets, but avoid confusing diversification with guaranteed protection.
30. Compare unhedged and hedged versions of foreign funds, including cost, volatility, and tax consequences.
31. Watch real rates, central bank credibility, current-account trends, reserve adequacy, and political risk.
32. Do not use leverage in FX unless you can survive violent gap moves and funding stress.

15.2 For a company

33. Map transaction, translation, and economic exposures by currency and maturity.
34. Identify natural hedges before buying derivatives.
35. Set hedge ratios based on certainty of cash flows, not market emotions.
36. Use forwards for committed exposures and options for uncertain exposures where upside matters.
37. Match debt currency to cash-flow currency when possible.
38. Stress test a 10%, 20%, and 30% currency move against margins, covenants, liquidity, and pricing power.
39. Establish board-approved FX policy, counterparty limits, and reporting standards.

15.3 For country-risk analysis

- Current-account balance and export concentration.
- Foreign-currency debt relative to reserves and exports.
- Short-term external debt rollover needs.
- Real interest-rate credibility.
- Inflation trend and central bank independence.
- Fiscal balance and sovereign credit risk.
- Political stability, sanctions exposure, and capital-control risk.
- Banking-system foreign-currency mismatch.

Conclusion: FX Is the Price of Trust, Rates, and Capital Movement

Exchange rates are not random numbers. They are the moving price of national credibility, monetary discipline, external balance, capital mobility, geopolitical trust, and financial liquidity. They translate the abstract power of states and central banks into the concrete costs faced by exporters, importers, students, travelers, borrowers, investors, and governments.

A currency can be strong because its country offers high real yields, low inflation, credible institutions, deep markets, export competitiveness, safe assets, and geopolitical trust. A currency can be weak because markets demand compensation for inflation, debt, instability, external deficits, shallow markets, or policy error.

The dollar-centered system makes FX analysis inseparable from U.S. rates, Treasury markets, global dollar funding, and crisis liquidity. For many countries, the exchange rate is not only a national price. It is the local reflection of the global dollar cycle.

The practical discipline is balance-sheet clarity. Know the currencies of your income, expenses, assets, liabilities, and future commitments. Hedge necessities. Diversify long-term wealth. Avoid leverage without survival capacity. Treat exchange rates as signals of power, trust, and capital movement - not merely as the price of money.

Appendix A: Glossary

Appreciation: A rise in a currency’s value relative to another currency.

Depreciation: A fall in a currency’s value relative to another currency.

Bid: The price at which a dealer buys the base currency.

Ask: The price at which a dealer sells the base currency.

Spread: The difference between bid and ask; a basic transaction cost.

Real exchange rate: A nominal exchange rate adjusted for relative price levels.

Current account: Trade balance plus income flows and transfers.

Capital account / financial account: Cross-border flows of investment, borrowing, lending, and asset ownership.

Carry trade: Borrowing in a low-yielding currency to invest in a higher-yielding currency.

FX reserves: Foreign assets held by a central bank for stability, intervention, and external payments.

Safe-haven currency: A currency investors tend to buy during stress because of liquidity and trust.

Currency mismatch: A balance-sheet mismatch where income and liabilities are in different currencies.

Forward: A contract to exchange currencies at a future date at a specified rate.

Option: A right, not an obligation, to exchange currencies at a specified rate.

Swap line: A central bank arrangement to provide foreign-currency liquidity during stress.

Appendix B: Source Notes and Institutional References

[1] Bank for International Settlements, Triennial Central Bank Survey 2025: OTC foreign exchange turnover in April 2025. The survey reported global OTC FX turnover of about $9.6 trillion per day and the dollar on one side of 89.2% of trades. URL: https://www.bis.org/statistics/rpfx25_fx.htm

[2] Federal Reserve, The International Role of the U.S. Dollar - 2025 Edition. The report describes the dollar's share of disclosed global official foreign reserves and compares it with other major reserve currencies. URL: https://www.federalreserve.gov/econres/notes/feds-notes/the-international-role-of-the-u-s-dollar-2025-edition-20250718.html

[3] Federal Reserve Board and Federal Reserve Bank of New York, International Roles of the U.S. Dollar conference materials, describing the dollar's preeminent role in investment, funding, payments, trade, and reserves. URL: https://www.federalreserve.gov/conferences/fifth-conference-on-the-international-roles-of-the-us-dollar.htm

[4] U.S. Treasury, Treasury International Capital System, which tracks foreign holdings and transactions in U.S. securities, including Treasury securities. URL: https://home.treasury.gov/data/treasury-international-capital-tic-system

[5] IMF COFER, Currency Composition of Official Foreign Exchange Reserves, a core dataset for the currency composition of global reserve holdings. URL: https://data.imf.org/en/datasets/IMF.STA:COFER

[6] Cleveland Fed, On the Safe-Haven Status of the Dollar, remarks on how safe-haven demand relates to trust, liquidity, and the Federal Reserve's commitments. URL: https://www.clevelandfed.org/collections/speeches/2026/sp-20260306-on-the-safe-haven-status-of-the-dollar

Appendix C: One-Page FX Reading Template

Question	What to inspect	Why it matters
What is the rate regime?	Float, peg, band, managed float, controls	Defines central bank constraints and intervention risk
What are real rates doing?	Policy rate minus expected inflation	Real yield drives savings and capital allocation
Is the external balance stable?	Current account, reserves, short-term debt	Reveals need for foreign financing
Who owns the assets?	Foreign equity/bond flows, bank funding	Capital flows can overpower trade flows
Is debt in local or foreign currency?	Sovereign and corporate debt currency	Currency mismatch creates crisis leverage
What is the dollar cycle?	Fed path, Treasury yields, DXY, global risk	Dollar cycle transmits global financial conditions
Is the central bank credible?	Inflation, independence, intervention record	Credibility lowers depreciation risk
What is market sentiment?	Volatility, CDS, equity flows, reserves	Sentiment controls short-run FX pressure