

Research

What cover prices can tell us about EMEA FX valuation

The financial magazine *The Economist* has made the so-called ‘Big Mac Index’ famous. The Big Mac Index uses the price of a Big Mac to illustrate the so-called Law of One Price, by comparing the price of a Big Mac in different countries and thereby saying something of the valuation of the respective currencies. The Law of One Price basically says that any (tradable) good should have the same price in all countries in the long run. Hence, simply put, if a Big Mac is more expensive in Poland than Hungary (measured by those currencies) then the Polish zloty is overvalued relative to the Hungarian forint.

What the good people at *The Economist* may not realise that the magazine *itself* provides a good – and easy assessable illustration of the Law of One Price. The price of the magazine in different countries is printed on the cover of every edition of *The Economist*. For example, its price is PLN26.5 in Poland and EUR5.5 in all euro countries. So for the Law of One Price to hold EUR/PLN should be trading at 4.82 – somewhat higher than the actual EUR/PLN rate. Therefore, either the zloty is around 17% overvalued against the euro or *The Economist* needs to reduce its price by a similar amount in Poland for the Law of One Price to hold.

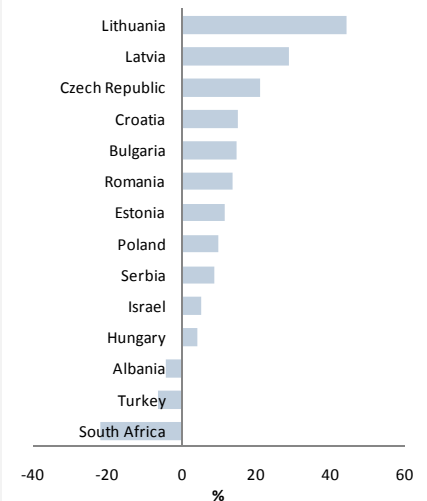
We naturally do not suggest that this in any way is a scientific measure of the valuation of the zloty or any other currency, but it is nonetheless an illustration of the Law of One Price that might provide some insight about currency valuation. We have therefore, used the cover price of the latest edition of *The Economist* to look at the valuation of a number of EMEA currencies. To provide one more measure we have made the same calculation by using the cover price of the *Financial Times*. The results of our calculations are shown on the right-hand side of the page. According to the cover prices of both *The Economist* and the *Financial Times*, most of the EMEA currencies are “overvalued” relative to the euro. It is particularly notable when the calculations are based on cover prices of *The Economist*.

Again we stress that this exercise is done for illustrative purposes and is not intended as an exact measure of currency valuation anywhere. Some interesting patterns nonetheless emerge from the calculations. Hence, the cover prices of both magazines indicate a quite significant overvaluation of all three Baltic currencies, in line with the common perception in the financial markets. From this study, the Lithuanian lita is the most overvalued of all the EMEA currencies. Another notable result is that the currencies most closely linked to the euro either through a fixed exchange rate policy (the Baltic States and Bulgaria) or have quasi-fixed or managed floating exchanges (for example Romania and Croatia) tend to be more overvalued than the currencies that are freely floating – and this is especially the case for the non-European currencies – the Turkish lira and the South African rand.

Concluding, this is only an illustration of the Law of One Price and is not a scientific excise, but if one believes that the cover prices of *The Economist* and the *Financial Times* provide a good measure of the fair valuation for the EMEA currencies (we do not say they do) then one might buy a the lira and the rand against a basket of CEE currencies.

EMEA FX valuation

"Cover price" valuation



Source: *The Economist*, *Financial Times* and Danske Markets calculations

Note: Valuation calculations are based on the average exchange rates “predicted” from the cover prices of *The Economist* and the *Financial Times*.

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