Jasmine - The Economist

Week 19 Essay: Big Mac Index

Concisely think of arguments:

- Why the Big Mac Index may be a good measure of currency values;

- Why it may be a bad measure of currency values.

Introduced by The Economist in 1986, the Big Mac index is an informal way to measure and explain "purchasing-power parity", by comparing the prices of McDonald's Big Mac burger in different countries. In economist, purchasing-power parity measures the differences in purchasing power of the same goods and service in two countries. It refers that the same amount of money can buy the same amount of the goods in all countries. According to the theory, the foreign exchange rates should adjust to equal the price of the identical basket of goods and services in different countries. (The Economist, 2012)

Since McDonald has standard recipe and regulations of Big Mac production and the hamburger is available in around 120 countries, the Big Mac is chosen by The Economist as the benchmark to facilitate the comparison between the purchasing power of different currencies. The Big Mac Purchasing Power Parity is the exchange rate which equalizes the Big Mac price of America and another country. By comparing the actual currency exchange rates with the Big Mac exchange rates, we can conclude whether a currency is under- or overvalued. (The Economist, 1998)

Even though it was first intended to explain the purchasing-power parity in a simple way, it is considered as a crucial and serious economy index by most people. Upon its first introduction, it has become one of the most popular indicators predicts the trend of exchange rate. It also provides somehow accurate investment tips for investors. Thanks to its popularity, The Big Mac index even gives rise to a term – Burgernomics.

Every coin has two sides. Some people argue that Big Mac Index is a good measure of currency values while the others do not take it for granted. As far as I am concerned, there is no doubt that the Big Max index has certain merits. However, we should not ignore its shortcomings as well. In this essay, both the advantages and disadvantages will be analyzed.

Advantages

To begin with, using Big Mac burger as the benchmark is the most simple and direct way to measure and explain the theory of purchasing-power parity. Big Mac is a standard product which is almost available everywhere in the world. Besides, McDonald's has a rigid system to keep every product the same quality. It also adjusts the product price timely reflecting the market trend. Therefore, it is very effective and easy to get the Big Mac index because it only relies on the same product. Moreover, compared with other sophisticated methods which gather thousands of products data and take several years for research, the big mac result is more direct, instant and even correct because of its timely information.

In the second place, the facts show that the Big Mac index can correctly predict the long term movements in the exchange rates to some extent. Euro is the one of the best examples. When the euro was launched in 1999, almost everybody assured it would immediately rise against the dollar. But the Big Mac index suggested that the euro was already overvalued. Not surprisingly, the euro promptly fell just as the index presented. (The Economist, 2011) Today, the index still suggests the euro is overvalued and it precisely points out the problem of euro crisis. From the Big Mac index, the euro was 21% overvalued against the US dollar in 2011. Suffering from the European sovereign-debt crisis recently, the euro has already fallen to the 16-month low against the US dollar. (The Economist, 2012) And now it is only 6% overvalued against the US dollar according to the latest index in January 2012. Therefore, many investors regard it as the investment guide.

Disadvantages

The Big Mac index can only be one of the indicators measuring the currency value. In fact, it cannot be the perfect measure of purchasing-power parity. People cannot rely too much on it because the price of Big Mac is not absolutely independent. In different countries, the burger price is adjusted by the worker's wages, local land price, taxes, local consumer behaviors and competitors etc.

Feeling threatened by the emerge of China's economy, American politicians even used the Big Mac index to demand for the big appreciation of Chinese yuan.(The Economist, 2011). From the chart below, a $4.2 US

The Economist Big Mac index, January 2012

Country	Big Mac prices in local currency	Big Mac prices in dollars*	Implied PPP† of the dollar	Actual dollar exchange rate January 11th 2012	Under (-)/ over (+) valuation against the dollar, %
United Sta	$ 4.20	4.20	-	-	-
Argentina	Peso 20.0	4.64	4.77	4.31	10
Australia	A$4.80	4.94	1.14	0.97	18
Brazil	Real 10.25	5.68	2.44	1.81	35
Britain	£2.49	3.82	1.69§	1.54	-9
Canada	C$4.73	4.63	1.13	1.02	10
Chile	Peso 2,050	4.05	488	506	-3
China**	Yuan 15.4	2.44	3.67	6.32	-42
Colombia	Peso 8,400	4.54	2001	1852	8
Costa Rica	Colones 2,050	4.02	488	510	-4
Czech Rep	Koruna 70.22	3.45	16.73	20.4	-18
Denmark	DK 31.5	5.37	7.50	5.86	28
Egypt	Pound 15.5	2.57	3.69	6.04	-39
Euro area†	€ 3.49	4.43	1.20	1.27§§	6
Hong Kong	HK$ 16.5	2.12	3.93	7.77	-49
Hungary	Forint 645	2.63	153.67	246	-37
India***	Rupee 84.0	1.62	20.01	51.9	-61
Indonesia	Rupiah 22,534	2.46	5369	9160	-41
Israel	Shekel 15.9	4.13	3.79	3.85	-2
Japan	Yen 320	4.16	76.24	76.9	-1
Latvia	Lats 1.65	3.00	0.39	0.55	-29
Lithuania	Litas 7.8	2.87	1.86	2.72	-32
Malaysia	Ringgit 7.35	2.34	1.75	3.14	-44
Mexico	Peso 37	2.70	8.82	13.68	-36
New Zeala	NZ$ 5.10	4.05	1.22	1.26	-4
Norway	Kroner 41	6.79	9.77	6.04	62
Pakistan	Rupee 260	2.89	61.95	90.1	-31
Peru	Sol 10.0	3.71	2.38	2.69	-12
Philippines	Peso 118	2.68	28.11	44.0	-36
Poland	Zloty 9.10	2.58	2.17	3.52	-38
Russia	Rouble 81.0	2.55	19.30	31.8	-39

Big Mac is sold at 15.4 yuan in China, suggesting that Chinese yuan is 42% undervalued against the US dollar.

However, they neglect other factors that contributing the cheap Big Mac in China. Firstly, the labor cost is much lower in China than in the United States. Generally, the average wage of a normal Chinese worker is only the tenth of an American worker. Moreover, the Chinese eating habit is much more different from American. American take McDonald's as their daily meal while Chinese people prefer rice and steamed food. They regard the western fast food as "junk food". Hence, it is not common for a Chinese to eat McDonald's every day. With the more and more people realizing the concept of healthy life style, Chinese people reduce the frequency of eating fast food. The latest status even shows that the number of McDonald's is reducing in China. Therefore, McDonald's has to use a relatively cheap price to attract Chinese customers. Therefore, it is not fair and unreasonable to assert Chinese yuan is much undervalued simply by a hamburger price.

Conclusion

The Big Mac index is an informal method to explain "purchasing-power parity", by comparing the prices of McDonald's Big Mac burger in different countries. Many people believe it can precisely measure the currency value and indicate the long term trend of the exchange rates. To sum up, the Big Mac index can reflect whether a currency is overvalued or undervalued to some extent. However, it cannot be the perfect measure of purchasing-power parity as the price of Big Mac is affected by various factors in different countries. When measuring the currency value, besides the Big Mac index, we should also consider other index such as GDP.

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