11. The International Monetary and Financial Environment

Asst. Prof. Dr. Ilke Kardes

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Read chapter 11
Learning Objectives

1. Exchange rates and currencies in intl. business
2. How exchange rates are determined
3. Emergence of the modern exchange rate system
4. The monetary and financial systems
5. Key players in the monetary and financial systems
Currency & Exchange rate

Global financial and monetary system
More than 150 currencies in use worldwide.

Individual currency, e.g., U.S. Dollar  
Currency union, e.g., Euro  
Dollarization, e.g., in Panama

Convertible currency
- Can be readily exchanged for other currencies
- Universally accepted for intl. transactions
- Called hard currency
- E.g., Dollar, Yen, Pound, Euro

Nonconvertible currency
- Not acceptable for intl. transactions
**Exchange rate:** The price of one currency in terms of another. It enables international price and cost comparisons.

**Foreign exchange:** All forms of internationally-traded money including foreign currencies, bank deposits, checks, and electronic transfers.

**Foreign exchange market:** The global marketplace for buying and selling national currencies.
The price of one currency in terms of another can be
- **depreciating** -- the loss of value, or
- **appreciating** -- an increase of value.

Suppose, last year, the exchange rate was €1 = $1. Now, suppose the rate has gone to: €1.50 = $1.

What is the effect of this change on European firms?

- Cost of import from the U.S. 🔺
- Profitability 🔻
- Prices 🔺
- Consumer demand 🔻
- Export to the U.S. 🔺
- Revenue 🔺
Why does the exchange rate change?

In a free market, the “price” of any currency (the exchange rate) is determined by **supply and demand**:

- the supply of a currency
- the demand for a currency

![Diagram of supply and demand](image)

**Equilibrium Price of Euros for Dollars**
Equilibrium Price of Euros for Dollars
Factors That Influence Exchange Rates

(1) Economic growth

(2) Inflation

(3) Market psychology

(4) Government actions
**Current account deficits**
- A country is spending more on foreign trade than it's earning.
- If the country is making up the deficit by borrowing capital from foreign sources, its currency will depreciate in value.

**Government debt**
- causes fears of high inflation by foreign investors.
- As a result, the value of the currency decreases.

(2) Inflation and Interest Rates

- Generally, countries with consistently high inflation rates have low currency values.

- This is because its purchasing power decreases relative to other countries.

- A rise in interest rates in one country can offer investors a higher return, relative to other countries.

- This can make that the currency value rise as it becomes more attractive to investors.

Herding. The tendency of investors to mimic each others’ actions.

Momentum trading. Buying stocks with rising prices, selling stocks with falling prices.

(3) Market psychology - Speculations

- Most transactions in the foreign exchange market are speculative trades.
- These can have a direct impact on exchange rates.

Central banks influence exchange rates by buying or selling the domestic currency to stabilize it.

Trade surplus = Export > Import
- a net inflow of foreign exchange
- an undervalued national currency

Trade deficit = Export < Import
- a net outflow of foreign exchange
- an overvalued national currency
- a possible devaluation of the currency by the government
- an undervalued national currency

Currency & Exchange rate

Global financial and monetary system
The agreement:
• sets the course for contemporary global financial relations
• was conceived by 44 nations at the Mount Washington Hotel in Bretton Woods, New Hampshire, U.S., in 1944.

Dissolve: in 1971, as the world economy was evolving and governments could no longer maintain fixed exchange rates on the gold standard.

The legacy: Bretton Woods established the concept of international monetary cooperation, especially aimed at minimizing currency risk.

>> International Monetary Fund (IMF) and World Bank
International monetary system: The institutional framework, rules, and procedures by which national currencies are exchanged for one another.

Global financial system:
- The collection of financial institutions that facilitate and regulate the flows of investment and capital funds worldwide.
- Includes the national and international banking systems, the international bond market, and national stock markets.
### Key Participants and Relationships

<table>
<thead>
<tr>
<th>The Level</th>
<th>The Participant</th>
<th>The Role</th>
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<tbody>
<tr>
<td>Firm</td>
<td>The Firm</td>
<td>needs for huge sums of foreign exchange to accomplish international transactions.</td>
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<td>National infrastructure</td>
<td>National Stock Exchanges and Bond Markets</td>
<td>facilitate for trading securities and bonds.</td>
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<tr>
<td>National government</td>
<td>Commercial Banks</td>
<td>- lend money to finance business activity.</td>
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<td></td>
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<td>- supply nations' money.</td>
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<td></td>
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<td>- exchange foreign currencies.</td>
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<td></td>
<td>Central Banks</td>
<td>- regulate money supply.</td>
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<td></td>
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<td>- manage exchange rates.</td>
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<td></td>
<td>IMF</td>
<td>- promotes exchange rate stability.</td>
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<td></td>
<td>World Bank</td>
<td>provides loans and technical assistance.</td>
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Financial Risk (Currency Risk)

**Currency exposure.**
General risk of unfavorable exchange rate fluctuations.

**Asset valuation.**
Risk that exchange rate fluctuations will adversely affect the value of the firm’s assets and liabilities.

**Foreign taxation.**
Income, sales, and other taxes vary widely worldwide, with implications for company performance and profitability.

**Inflation.**
High inflation, common to many countries, complicates business planning, and the pricing of inputs and finished goods.
Global Financial Crisis

Exchange rates against the dollar
May 1st 2013 = 100

- Russian rouble
- Chilean peso
- Indian rupee
- Brazilian real
- South African rand
- Argentine peso

Source: Economist 2014, Jan 27

The Growing Integration of Financial and Monetary Global Activity

- Evolution of monetary and financial regulations worldwide.
- Emergence of new technologies and payment systems in global finance; e.g., the Internet.
- Increased global and regional interdependence of financial markets.
- Growing role of single-currency systems, e.g., Euro.
Key Takeaways: CH 11

- Financial risk (currency risk)
- Convertible vs. nonconvertible currency

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<th>Economic growth</th>
<th>Inflation</th>
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<td>Market psychology</td>
<td>Government actions</td>
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Change in relation of supply and demand for currency

Fluctuation in exchange rate

Appreciation or depreciation of currency
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