STUDY GUIDE

Chapter 7

DEALING WITH FOREIGN EXCHANGE

Learning Objectives

After studying this chapter, you should be able to:

1. Understand the determinants of foreign exchange rates.
2. Track the evolution of the international monetary system.
3. Identify firms' strategic responses to deal with foreign exchange movements.
4. Participate in three leading debates concerning foreign exchange movements.
5. Draw implications for action.

Chapter Outline: Key Concepts and Terms

I. WHAT DETERMINES FOREIGN EXCHANGE RATES

1. Key Concept

A foreign exchange rate is the price of one currency expressed in another. Basic determinants of foreign exchange rates include (1) relative price differences and PPP, (2) interest rates, (3) productivity and balance of payments, (4) exchange rate policies, and (5) investor psychology.

2. Key Terms

Balance of payments: a country's international transaction statement.

Bandwagon effect: the result of investors moving as a herd in the same direction at the same time.

Capital flight: a phenomenon in which a large number of individuals and companies exchange domestic currencies for a foreign currency.

Clean (or free) float: a pure market solution to determine exchange rates.

Dirty (or managed) float: the common practice of determining exchange rates through selective government intervention.

Fixed rate policy: fixing the exchange rate of a currency relative to other currencies.

Foreign exchange rate: the price of one currency in terms of another.

Floating (or flexible) exchange rate policy: the willingness of a government to let the demand and supply conditions determine exchange rates.

International Monetary Fund (IMF): an international organization of 185 member countries that was established to promote international monetary cooperation, exchange stability, and orderly exchange arrangements; to foster economic growth and high levels of employment; and to provide temporary financial assistance to countries to help ease balance of payments adjustment**.**

Peg: a stabilizing policy of linking a developing country's currency to a key currency.

Purchasing power parity: a theory that suggests that in the absence of trade barriers (such as tariffs), the price for identical products sold in different countries must be the same.

Target exchange rates (or crawling band): a limited policy of intervention, occurring only when the exchange rate moves out of the specified upper or lower bounds.

II. EVOLUTION OF THE INTERNATIONAL MONETARY SYSTEM

1. Key Concept

The international monetary system evolved from the gold standard (1870–1914), to the Bretton Woods system (1944–1973), and eventually to the current post-Bretton Woods system (1973–present). The IMF serves as a lender of last resort to help member countries fight balance of payments problems.

2. Key Terms

Bretton Woods system: a system in which all currencies were pegged at a fixed rate to the U.S. dollar.

Gold standard: a system in which the value of most major currencies was maintained by fixing their prices in terms of gold, which served as the **Common denominator.**

Post–Bretton Woods system: a system of flexible exchange rate regimes with no official common denominator.

Quota: the financial contribution, capacity to borrow, and voting power of IMF member countries that is based broadly on its relative size in the global economy.

III. STRATEGIC RESPONSES TO FOREIGN EXCHANGE MOVEMENTS

1. Key Concept

Three foreign exchange transactions are: (1) spot transactions, (2) forward transactions, and (3) swaps. Firms' strategic responses include (1) currency hedging, (2) strategic hedging, or (3) both.

2. Key Terms

Bid rate: the price offered to buy a currency.

Currency hedging: a transaction that protects traders and investors from exposure to the fluctuations of the spot rate.

Currency risks: the fluctuations of the foreign exchange market.

Currency swap: a foreign exchange transaction in which one currency is converted into another in Time 1, with an agreement to revert it back to the original currency at a specific Time 2 in the future.

Foreign exchange market: a market where individuals, firms, governments, and banks buy and sell foreign currencies.

Forward discount: when the forward rate of one currency relative to another currency is higher than the spot rate.

Forward premium: when the forward rate of one currency relative to another currency is lower than the spot rate.

Forward transaction: a foreign exchange transaction in which participants buy and sell currencies now for future delivery, typically in 30, 90, or 180 days, after the date of the transaction.

Moral hazard: refers to recklessness when people and organizations (including governments) do not have to face the full consequences of their actions.

Offer rate: the price offered to sell a currency.

Spot transaction: the classic single-shot exchange of one currency for another.

Spread: the difference between the offered price and the bid price.

Strategic hedging: spreading out activities in a number of countries in different currency zones to offset the currency losses in certain regions through gains in other regions.

IV. DEBATES AND EXTENSIONS

1. Key Concepts

Debates: (1) fixed versus floating exchange rates, (2) a strong versus a weak dollar, and (3) currency hedging versus not hedging.

2. Key Terms

Currency board: a monetary authority that issues notes and coins convertible into a key foreign currency at a fixed exchange rate.

V. MANAGEMENT SAVVY

1. Key Concept

Fostering foreign exchange literacy is a must. Risk analysis of any country must include an analysis of its currency risks. A currency risk management strategy is necessary via currency hedging, strategic hedging, or both.