Chapter 9


# The International Monetary and Financial Environment

## Presented by
## Prof. Dr. Zafar U. Ahmed

# Currencies and Exchange Rates

- More than 150 currencies in use worldwide.
- Currency regimes are simplifying. e.g., The euro in Europe; the dollar in Panama and Belize.
- Most currencies are not very *convertible*. The dollar, yen, pound, euro are **hard currencies** – universally accepted and preferred in international transactions.
- **Exchange rate**: Price of one currency in terms of another.
- Exchange rates affect the fortunes of the firm in various ways – costs of inputs, sales performance, which market entry strategies to use, etc.

# Constantly fluctuating exchange rates require international managers to keep in mind three facts

- The prices the firm charges can be quoted in the firm’s currency or in the currency of each foreign customer.
- Because several months can pass between placement and delivery of an order, fluctuations in the exchange rate during that time can cost or earn the firm money.
- The firm and its customers can use the exchange rate as it stands on the date of each transaction, or they can agree to use a specific exchange rate.

# Foreign Exchange Markets

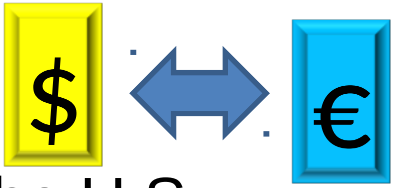
- **Foreign exchange**: All forms of internationally-traded monies including foreign currencies, bank deposits, checks, and electronic transfers.
- **Foreign exchange market**: The global marketplace for buying and selling national currencies.


Exchange rates are in constant flux. In 2012, for example, the Indian rupee was trading at 48 rupees to the U.S. dollar. By 2013, the rate had depreciated to 58 rupees—the rupee's value went down relative to the dollar by more than 20 percent.

- This shift made the rupee less expensive for Americans, and the U.S. dollar more expensive for Indians. Such shifts can complicate international business.

# Example: Euro vs. the Dollar

- 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 Europeans?




*Effect on European Firms:*

- ➢European firms pay more for inputs from the U.S.
- ➢Higher costs reduce profitability; require higher prices.
- ➢European firms can increase their exports to the U.S.
- ➢European firms can raise their prices to the U.S.
- ➢Increased exports to the U.S. lead to higher revenues.

*What is the effect on European consumers?*

# How Exchange Rates Are Determined

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

- The greater the supply of a currency, the lower its price.
- The lower the supply of a currency, the higher its price.
- The greater the demand for a currency, the higher its price.
- The lower the demand for a currency, the lower its price.


*Source:* david_franklin/Fotolia

# Factors that Influence the Supply and Demand for a Currency

***Economic growth*** is the increase in value of the goods and services produced by an economy.

- Measured as the annual increase in real GDP (in which the inflation rate is subtracted from growth).
- Driven by entrepreneurship and innovation.
- The nation's **central bank** regulates the money supply, issues currency and manages the exchange rate, to accommodate economic growth.


***Market psychology*** refers to investor behavior, such as herding behavior or momentum trading.

# Factors that Influence the Supply and Demand for a Currency (cont'd)

***Inflation*** refers to increases in the prices of goods and services; thus, money buys less than before.

- Some countries (e.g., Argentina, Israel, Russia) have experienced *hyperinflation*.
- High inflation erodes a currency's purchasing power.
- *Interest rates* and inflation are positively related; high inflation forces banks to pay high interest.
- That is, investors expect to be compensated for inflation-induced decline in the value of their money.

*Example:* If inflation is 10%, banks must pay more than 10% to attract deposits.

# Factors that Influence the Supply and Demand for a Currency (cont'd)

- ***Government action*** – Governments intervene to influence the value of their own currencies, e.g., the Chinese government regularly intervenes in the foreign exchange market to keep the *renminbi* undervalued, to help ensure exports.
- ***Balance of payments*** is the nation's balance sheet of trade, investment, and transfer payments with the rest of the world. It reflects the difference between the total amount of money coming into and going out of a country.

*Source:* Arto/Fotolia

# Value of the Currency and Trade Surplus vs. Trade Deficit

- **Trade surplus** – Exports exceed imports; may result when the exporter's currency is undervalued, as in China's official policy regarding its currenc
- **Trade deficit** – Imports exceed exports; the government may *devalue* the nation's currency to correct a trade deficit.
- **Balance of trade** – The difference between the value of a nation's exports and its imports.

Example:

Japan exports cars to the U.S. Car importers in the U.S. pay exporters in Japan, resulting in a surplus item in Japan's balance of trade and a deficit in the U.S. balance of trade.

If the total value of U.S. imports from Japan exceeds the total value of U.S. exports to Japan, then Japan will have a trade deficit with the U.S.

What other factors cause trade deficits?

# Development of the Modern Exchange Rate System

- After the Great Depression and World War II, the world economy and trading system were in a sorry state.
- At war's end, seeking stability in the international monetary and financial systems, 44 countries signed the Bretton Woods agreement.
- Bretton Woods established a fixed exchange rate system in which the U.S. dollar was pegged to a set value for gold ($35 per ounce), and other major currencies were pegged to the dollar.
- For nearly 30 years, the system kept exchange rates of major currencies at a fixed level.

# Breakdown and Legacy of Bretton Woods

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

- Concept of international monetary cooperation, especially aimed at minimizing currency risk.
- ***International Monetary Fund (IMF)***: Agency that promotes exchange rate stability, monitors exchange systems, provides funding to developing economies.
- ***World Bank***: Agency that provides loans and technical assistance to combat global poverty around the world.

# The Exchange Rate System Today

- Today, advanced economy currencies (dollar, euro, pound, yen) float according to market forces, their value determined by supply and demand.
- Conversely, most developing and emerging economies use *fixed exchange rate systems*.
- In fixed regimes, the value of a currency is pegged to the value of another, or to a basket of currencies, at a specified rate.

<u>Examples</u>

- China pegs its currency to a basket of currencies
- Belize pegs its currency to the dollar.

# The International Monetary and Financial Systems

- **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. It includes the national and international banking systems, the international bond market, and national stock markets.


*Source:* Gang Liu/Shutterstock

# Globalization of Financial and Monetary Activities

Growing integration of financial and monetary global activity is due to:

- 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., the Euro.

Source: Tan Kian Khoon/Shutterstock

# Key Participants in the Monetary and Financial Systems

- ***The Firm***. International transactions require firms to deal with huge sums of foreign exchange.

- ***National Stock Exchanges and Bond Markets***. Facilities for trading securities and bonds.

The stock exchange in Santiago, Chile

*Source:* Tifonimages/Fotolia

# Key Participants in the Monetary and Financial Systems

- ***Commercial Banks***. Lend money to finance business activity, play a key role in nations' money supplies, and exchange foreign currencies.
- ***Central Banks***. Regulate money supply, issue currency, manage exchange rates, control national reserves.
- ***Bank for International Settlements***. Supervises Central Bank monetary policy and other activities.

# Global Financial Crisis

- In 2008, a major crisis emerged in the global financial and monetary systems.
- It initially arose in the U.S., when investors lost confidence in the value of securitized home mortgages.
- Banks, lenders and insurance companies became volatile, and stock markets crashed worldwide.
- Many national economies sank into recession.
- The world experienced sharp declines in consumer wealth, economic activity, and international trade.

# Global Financial Crisis (cont’d)

- A key factor was the availability of “easy money”, from the U.S. Federal Reserve Bank.
- Also, China had been investing huge sums in U.S. government securities.
- These trends fostered a vast global money supply, which facilitated high demand for housing and commodities such as oil and food, leading to inflation.
- Much of the money was used to finance huge U.S. trade deficits.

# Global Financial Crisis (cont'd)

- Many bad mortgages were "securitized" – bundled into investment assets and sold in global financial markets.
- Over time, investors realized that many loans were high-risk, which led to **capital flight**.
- Like a contagion, the crisis spread quickly to Europe and beyond.
- As the global economy slowed, demand for exports shrank and export-dependent countries floundered (e.g., Japan, Mexico, countries in Eastern Europe).