

Chapter 20

International Finance

These slides supplement the textbook, but should not replace reading the textbook

What determines the exchange rates of different currencies?

The supply and demand for that currency on the international market

What determines the demand for a currency on the international market?

Foreigners demand a
another country's currency
for what that currency can
buy in that country

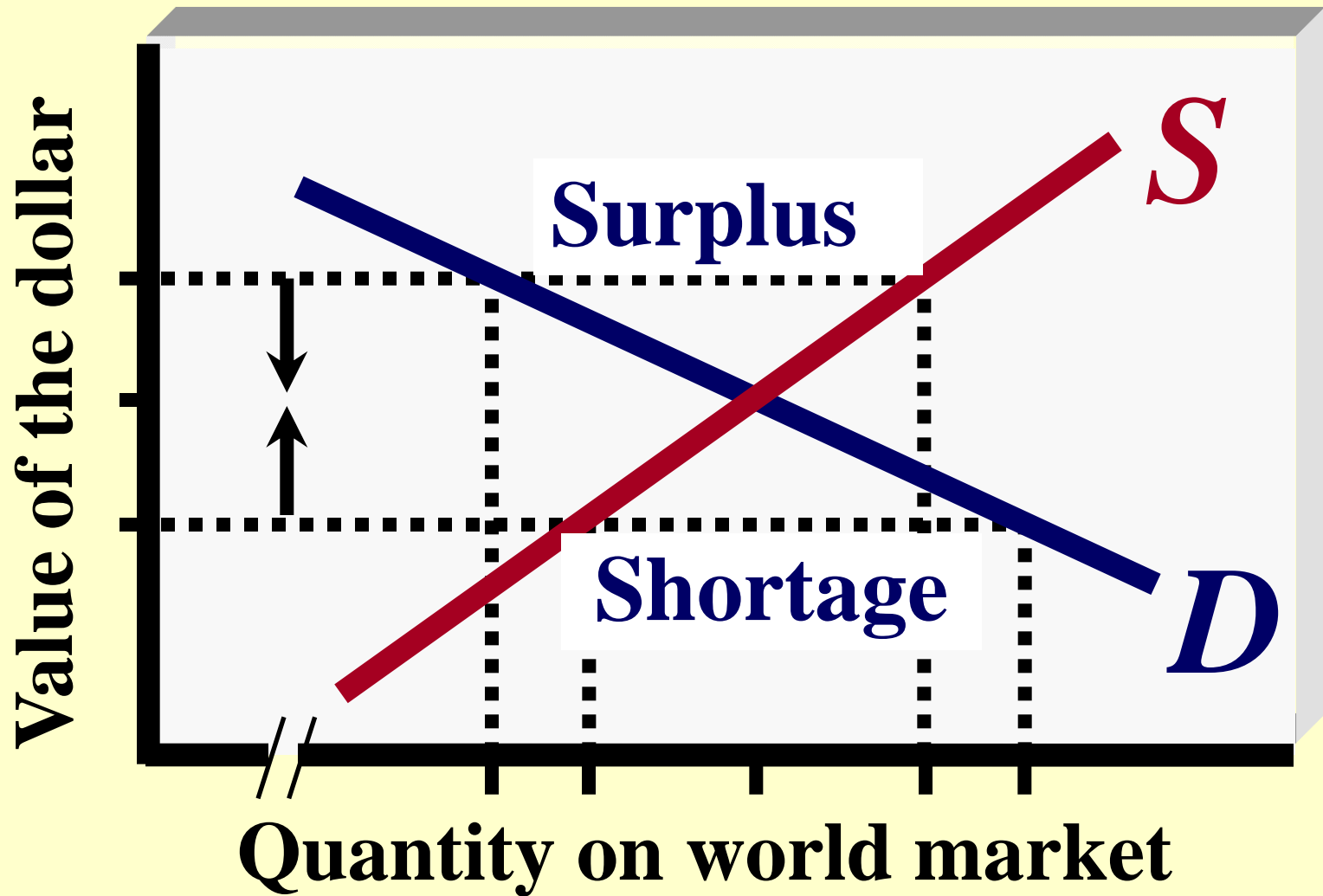
What determines the supply for a currency on the international market?

When citizens of a country buy goods and services from another country

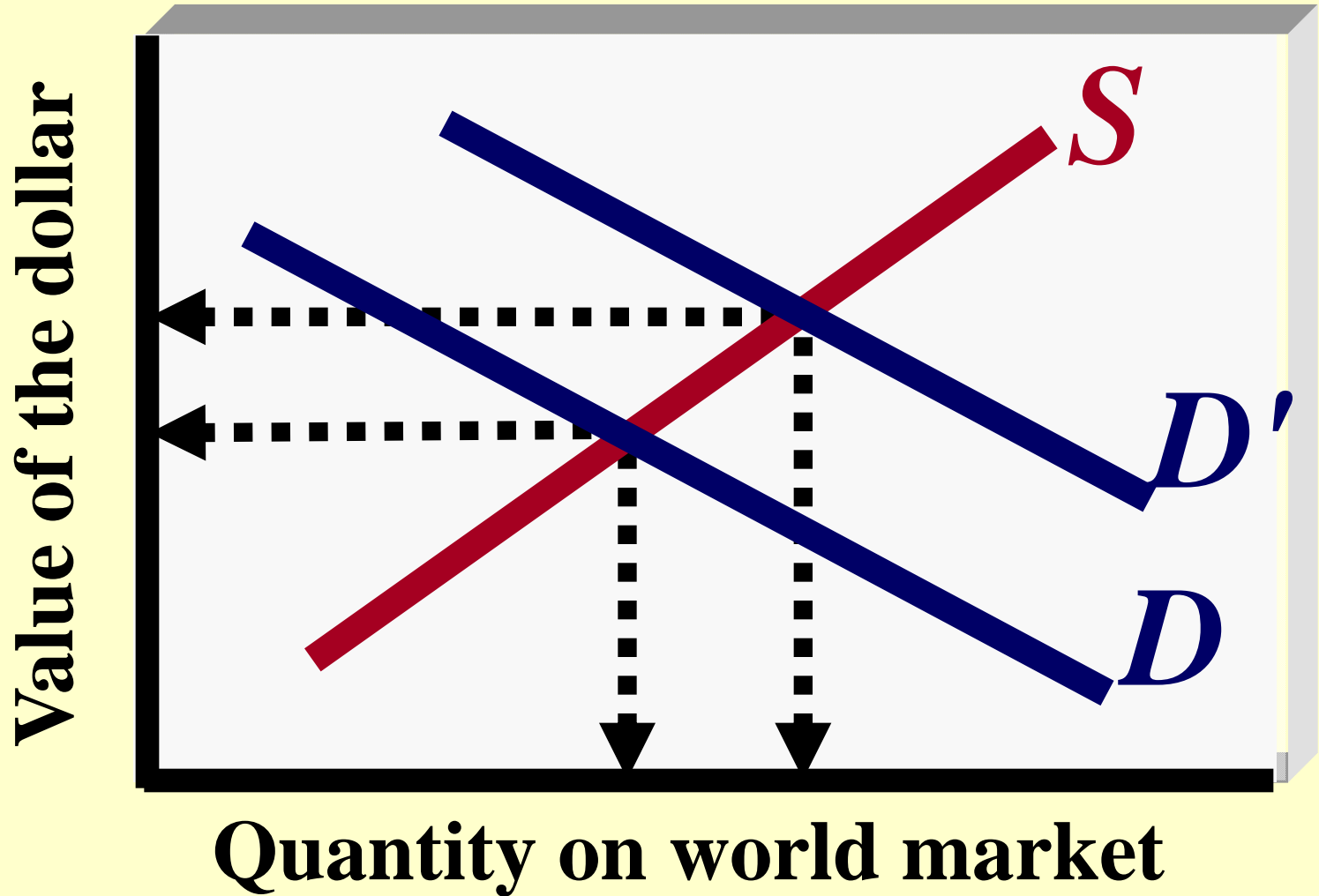
What are flexible exchange rates?

Rates are determined by the forces of demand and supply without government intervention

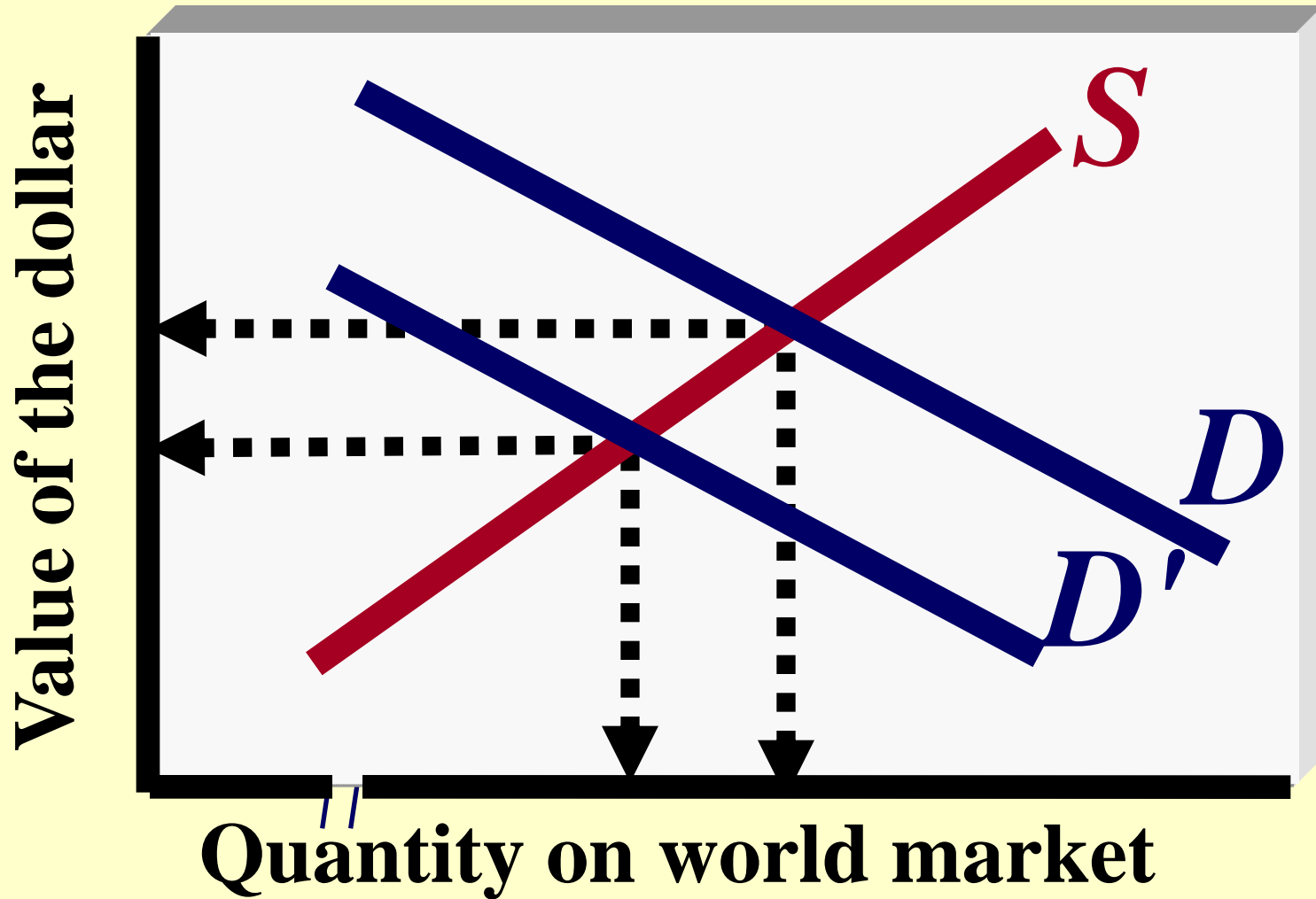
Equilibrium in the World Market



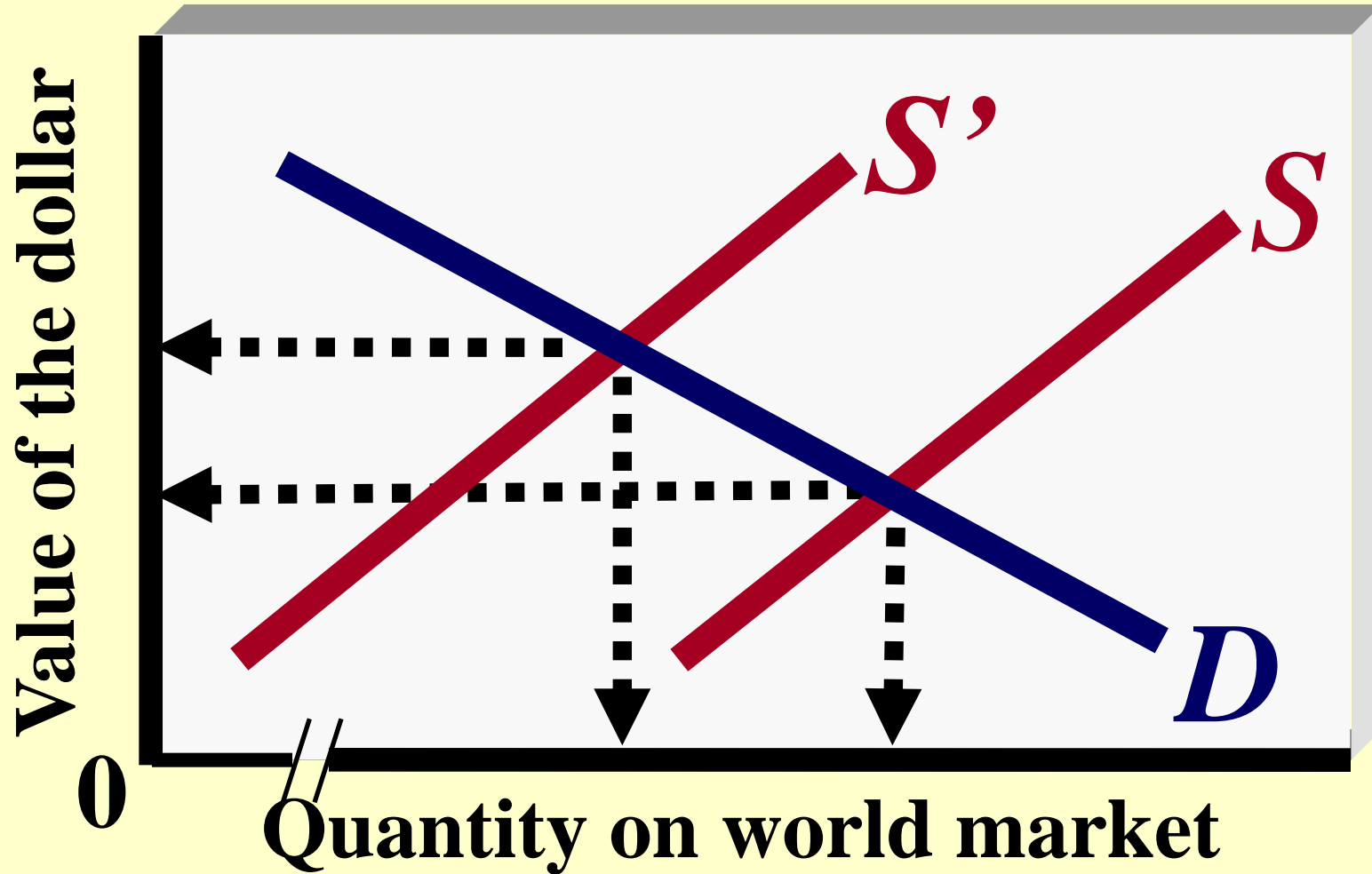
Effects of an Increase in Demand



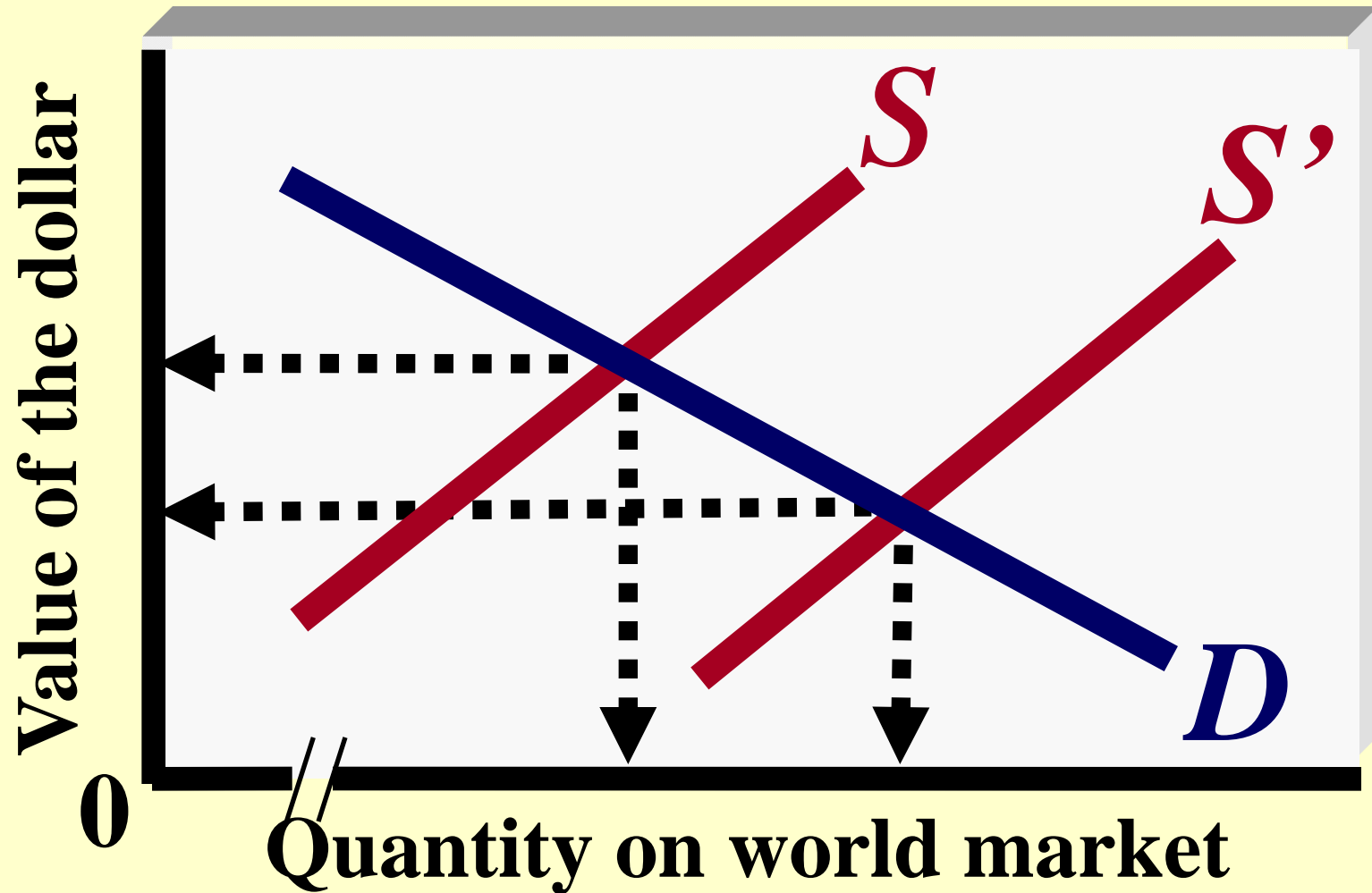
Effects of an Decrease in Demand



Effects of a Decrease in Supply



Effects of a Increase in Supply

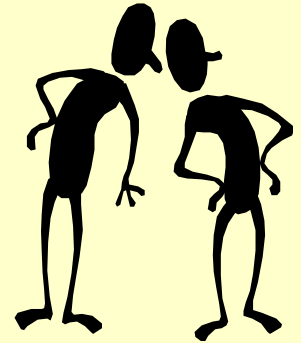


How do interest rates effect the demand for currencies?

If interest rates fall in country the demand for that currency will fall and it will depreciate and vice versa

What is a country's exchange rate?

The price of one country's currency measured in terms of another country's currency

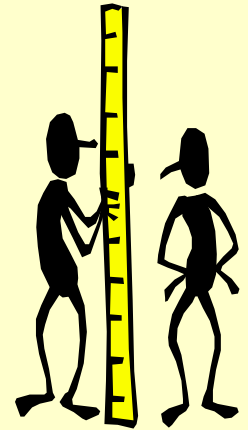


What determines different exchange rates? Relative ...

- price levels
- rates of interest
- rates of growth
- political & economic stability

What does it mean when a currency is depreciated?

An increase in the number of units of a particular currency needed to purchase one unit of foreign exchange



What does it mean when a currency is appreciated?

A decrease in the number of units of a particular currency needed to purchase one unit of foreign exchange



What is a country's balance-of-payments?

Summarizes all economic transactions that occur during a given time period between residents of that country and residents of other countries

What is balance on goods and services?

The portion of a country's balance-of-payments account that measures the value of a country's exports of goods and services minus the value of its imports of goods and services

What is a net unilateral transfer?

The unilateral transfers (gifts and grants) received from abroad by residents of a country minus the unilateral transfers sent abroad

What is balance of current account?

The portion of a country's balance-of-payments account that measures that country's balance on goods and services plus its net unilateral transfers

What is a capital account?

The record of a country's international transactions involving purchases or sales of financial and real assets

What is a payments surplus?

When there is more money entering a country than there is leaving a country



When can a payments surplus be a problem?

If it is too favorable over time it can cause inflation



What is a payments deficit?

When there is more money leaving a country than there is entering a country

When can a payments deficit be a problem?

If it is too unfavorable it can cause unemployment



When is there a balance in the balance of payments?

When the amount of money entering equals the amount of money leaving

How are balance of payments problems resolved?

- With a lot more money entering over a time, a currency will appreciate in value
- With a lot more money leaving over time, a currency will depreciate in value

What is the merchandise trade balance?

The value of
merchandise exported
minus the value of
merchandise imported

What is a favorable balance of trade?

The value of a country's imports of goods is less than the value of its exports of goods

What is an unfavorable balance of trade?

The value of a country's imports of goods is greater than the value of its exports of goods

How can money leave or enter a country other than trade?

- investments
- travel
- sending gifts



Can the balance of payments offset the balance of trade?

Money can leave a country because of trade - but more money can enter the country in other areas

How does foreign trade effect GNP?

- An increase in exports increases GNP
- A decrease in exports decreases GNP



What is the gold standard?

An arrangement whereby the currencies of most countries are convertible into gold at a fixed rate

When was the gold standard?

From 1879 to 1914, the international financial system operated under a gold standard

What is one advantage of the gold standard?

Any increase in the money supply would be limited to a country's gold holdings

Did America honor payment in gold after WWI?

Yes!



If countries demanded
payment for goods
and services in gold
we would pay in gold

What happened to this practice of paying in gold?

During the Depression of the 1930's foreigners demanded payment in gold, thus depleting our gold supply

When did the gold standard end?

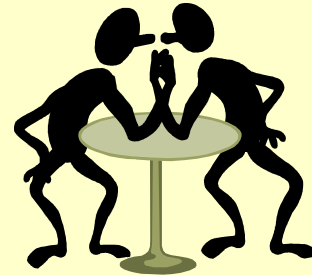
During World War I, the gold standard collapsed, limiting trade during the 1920s and 1930s

What is the fixed exchange rate system?

The value of each currency was pegged to an ounce of gold

When was the fixed exchange rate system?

From about 1945 to 1973



What was the Bretton Woods Agreement?

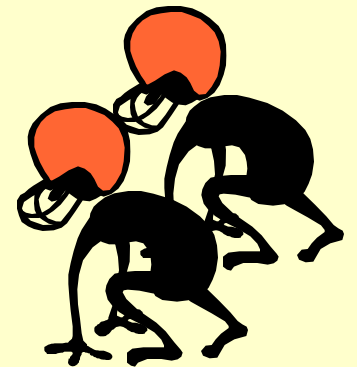
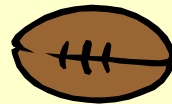
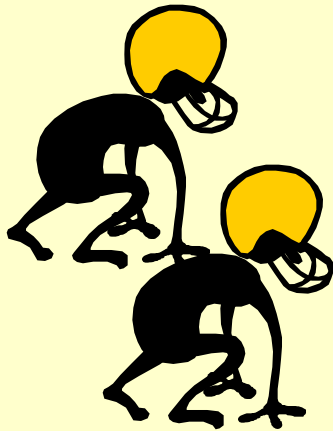
All foreign exchange rates were fixed in terms of the dollar and the dollar could be converted to gold at a fixed exchange rate

**Under the Bretton
Woods Agreement how
much did we agree to
exchange foreign
holdings of dollars?**

\$35 an ounce

When was the Bretton Woods Agreement?

1944



What is currency devaluation?

An increase in the official pegged price of foreign exchange in terms of the domestic currency

What is currency revaluation?

An reduction in the official pegged price of foreign exchange in terms of the domestic currency

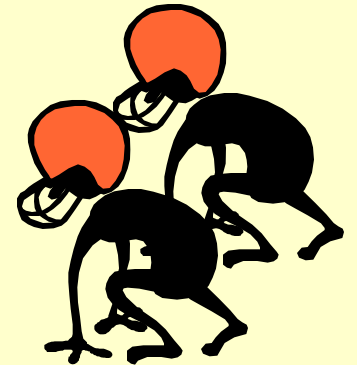
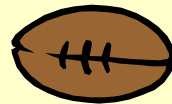
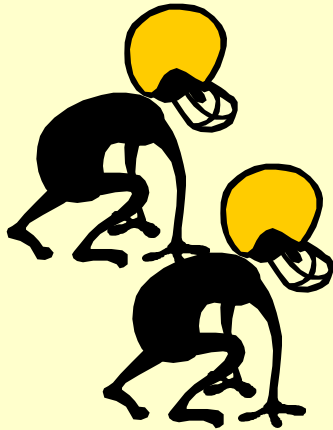
What is the International Monetary Fund?

Helps facilitate exchange rates by allowing countries to trade currencies



When was the IMF established?

1944

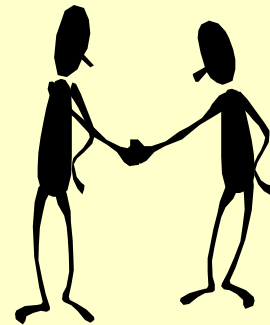


**How does the IMF help
countries influence their
exchange rates?**

- If the U.S. wants to devalue the dollar it will borrow dollars from the IMF and buy other currencies around the world
- If the U. S. wants to revalue the dollar it will borrow other currencies from the IMF and buy dollars around the world

What was the advantage of the fixed rate system?

Each country knew what its currency was worth in relation to foreign currencies

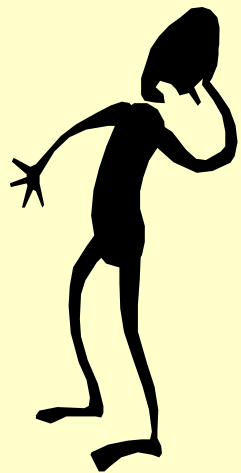


What happened to the fixed exchange rate system?

The inflation in the 1970's led to a change in the value of all currencies

Are major currencies still fixed?

No!



Major currencies today are allowed to fluctuate in value according to market forces

**What is it called
when currencies are
allowed to fluctuate?**

This is called floating



What is a dirty float?

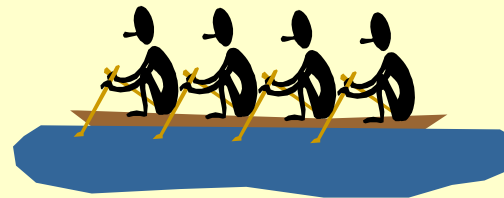
A dirty float occurs when a country influences the demand and/or supply of its currency on the international market

What is a managed float system?

An exchange rate system that combines features of freely flexible rates with intervention by central banks

What kind of system do we have today?

A managed float system



**Foreign exchange rates
tend toward equality
around the world
because of the actions of
Arbitrageurs**

Who is an arbitrageur?

A person who takes advantage of differences in exchange rates by purchasing in one market and selling in another market

Who is a speculator?

A person who buys or sells foreign exchange in hopes of profiting from fluctuations in the exchange rate over time

What is the difference between a speculator and an arbitrageur?

A arbitrageur buys and sells simultaneously, whereas a speculator does it over time

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