

Intro to International Finance

Exchange Rates
Balance of Payments
International Monetary Systems

International Finance

- Major Questions of International Finance:
 - What is the Balance of Payments, and what is the link between trade and investment flows?
 - What determines exchange rates in the short run? In the long run?
 - How do exchange rates affect prices and interest rates?
 - What is purchasing power parity?
 - How do international monetary systems work?

Intro International Finance

From these topics, we can answer the following questions:

- Is a “strong” US \$ better than a “weak” US\$?
- How do governments “defend” the exchange rate they want to maintain?
- How do fixed and flexible exchange rates function? Is one exchange rate mechanism better than the other?
- Is the EMU an “optimal currency union”? Is the US?
- What is dollarization, and why do some countries use the US\$ as their currency?
- What are the roles of the IMF and World Bank?

Some Stylized Facts on International Finance

- Most international transactions are financial rather than in goods/services
- The United Kingdom serves as the center of the world's financial transactions
 - In 1995, daily average of \$463.8 billion in transactions - roughly 1/4 of the \$1571.8 billion of daily global transactions
- The US dollar is involved in over 80% of all international transactions

Exchange Rates

- Exchange rates = “price” of a currency
 - How much of 1 currency you must give up to acquire the other currency
- In this way, one can view a currency as a commodity
 - Currency markets resemble goods markets
- Exchange rates can be fixed, managed, freely floating
- Note that demand for a foreign product indicates a demand for that currency, and a supply of your currency

Demand/Supply for Currency

- Demand for a currency is downward sloping in relation to its “price” (exchange rate)
- Supply of currency is upward sloping in relation to its “price” (exchange rate)
- The equilibrium exchange rate is the intersection of the demand and supply for that currency

Demand/Supply for Currency

- What causes the demand/supply for currency to change?
 - Changes in the demand/supply for foreign goods
 - Changes in the demand/supply for domestic goods
 - Changes in interest rates in both countries
 - Changes in political stability, resources, etc. in either country
- In other words, demand for currency is often a “derived demand”

Currency Appreciation/Depreciation

- A currency appreciates when its value rises
 - that is, it can command more foreign currency (FC) than it did previously
- A currency depreciates when its value falls
 - that is, it commands less FC than it did previously.
- Note, if ¥/\$ exchange rate rises, the US\$ has appreciated, while the ¥ has depreciated (since the \$/¥ rate fell)

Exchange Rate Arbitrage

- Is the ¥/\$ exchange rate the same in Tokyo as it is in New York?
 - Can we determine the ¥/\$ exchange rate if we know the £/\$ and the £/¥?
- We know that the existence of arbitrage opportunities motivated international trade –similarly, arbitrage opportunities exist in international finance
 - To determine if arbitrage opportunities exist with exchange rates, we must look at the “Cross Rates”
