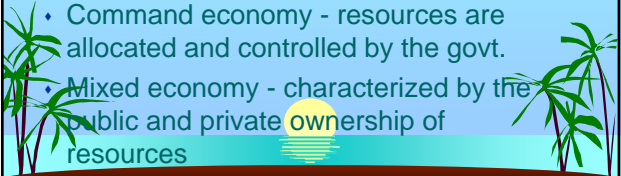


## The Economic Environment

- Market economy - resources are allocated and controlled by consumers who vote through buying goods/service
- The market mechanism involves an interrelationship of price, quantity, supply, and demand
- Command economy - resources are allocated and controlled by the govt.
- Mixed economy - characterized by the public and private ownership of resources



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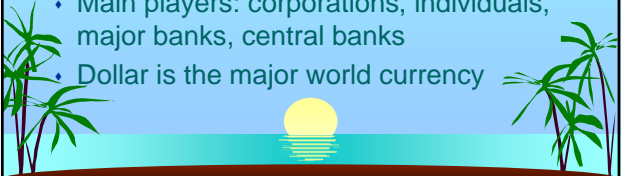
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## Foreign Exchange

- Major financial centers: Zurich, Paris, New York, Tokyo, London, Frankfurt, Singapore, Hong Kong, Bahrain, SF,
- Total volume estimated at \$ 50 trillion/yr
- Main players: corporations, individuals, major banks, central banks
- Dollar is the major world currency



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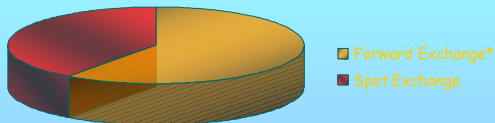
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## FX Transactions



\* Most forward exchanges are currency swaps.



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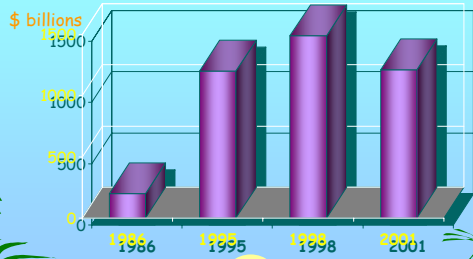
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## Foreign Exchange Trade Growth




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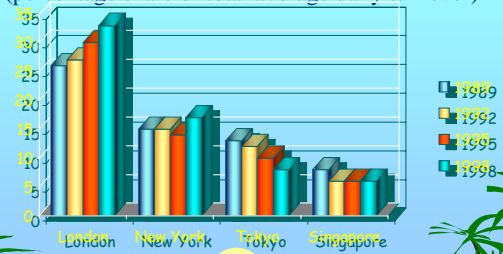
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## Geographical Distribution of Global Foreign Exchange Activity

(percentage share of total average daily turnover)




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## The Hierarchy of International Financial Centers



Note: Size of dots (squares) indicates cities' relative importance

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# Foreign exchange quotations, June 18, 2003

Table 9.1

Foreign Exchange Quotations, June 18, 2003

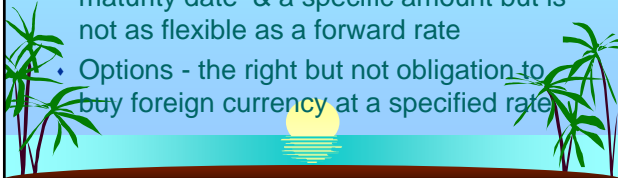
Source: Wall Street Journal, June 19, 2003, p. C12 Copyright© 2003 by DOW JONES & CO. INC. Reproduced with permission of DOW JONES & CO. INC. in paperback and CD-ROM format via the Copyright Clearance Center.

Key Currency Cross Rates						
	Dollar	Euro	Pound	SFranc	Yen	Gold
Canada	1.5267	1.5624	2.2441	1.1022	1.1709	0.1175
Japan	117.81	137.79	197.79	89.832	11.096	0.1116
Mexico	20.6100	22.0281	27.225	8.5480	—	2.9813
Netherlands	1.3211	1.5466	2.2225	—	1.1681	0.1122
NZ\$	0.5920	0.662	—	—	—	0.0526
Rupee	—	—	—	—	—	—
S\$	—	1.1682	1.4363	—	—	—
Sterling	—	—	—	—	—	—

Exchange Rates		U.S. \$ EQUIVALENT		CURRENCY	
Country	Rate	Rate	Rate	Rate	Rate
Argentina (Peso)	2720	2720	1.0000	1.0000	1.0000
Australia (Dollar)	0.7117	0.7117	1.4051	1.4051	0.7117
Brazil (Real)	2.760	2.760	0.3621	0.3621	2.760
Canada (Dollar)	0.6825	0.6825	1.4651	1.4651	0.6825
China (Yuan)	8.2756	8.2756	0.1208	0.1208	8.2756
Denmark (Krone)	6.46	6.46	0.1548	0.1548	6.46
France (Euro)	0.7036	0.7036	1.4211	1.4211	0.7036
Germany (Euro)	0.7036	0.7036	1.4211	1.4211	0.7036
India (Rupee)	47.848	47.848	0.0209	0.0209	47.848
Indonesia (Rupiah)	1336.7	1336.7	0.0007	0.0007	1336.7
Italy (Euro)	0.7036	0.7036	1.4211	1.4211	0.7036
Japan (Yen)	117.81	117.81	0.0085	0.0085	117.81
Korea (Won)	1100.0	1100.0	0.0009	0.0009	1100.0
Malaysia (Ringgit)	3.40	3.40	0.2941	0.2941	3.40
Mexico (Peso)	20.61	20.61	0.0485	0.0485	20.61
Netherlands (Euro)	0.7036	0.7036	1.4211	1.4211	0.7036
New Zealand (Dollar)	0.5920	0.5920	1.6892	1.6892	0.5920
Norway (Krone)	4.76	4.76	0.2101	0.2101	4.76
Portugal (Euro)	0.7036	0.7036	1.4211	1.4211	0.7036
Spain (Euro)	0.7036	0.7036	1.4211	1.4211	0.7036
Sweden (Krone)	8.46	8.46	0.1182	0.1182	8.46
Switzerland (Franc)	1.455	1.455	0.6873	0.6873	1.455
Taiwan (Dollar)	24.63	24.63	0.0406	0.0406	24.63
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UK (Pound)	0.7036	0.7036	1.4211	1.4211	0.7036
USA (Dollar)	1.0000	1.0000	1.0000	1.0000	1.0000
South Africa (Rand)	13.75	13.75	0.0727	0.0727	13.75
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UK (Pound)	0.7036	0.7036			

## Key Definitions

- Swap: is the simultaneous sale and purchase of a given amount of currency at two different date and values
- Futures - contracts for a specified maturity date & a specific amount but is not as flexible as a forward rate
- Options - the right but not obligation to buy foreign currency at a specified rate



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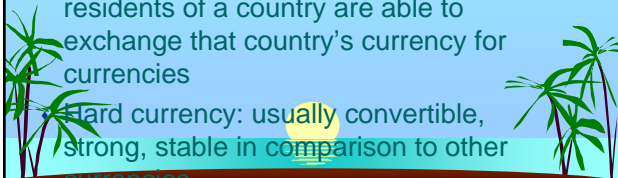
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## Key Definitions

- Cross Rates: exchange rate computed from two other exchange rates
- Spread in the spot market - difference between the bid (buy) and offer (sell) rates quoted in the F. E. market
- Convertible currency: residents & non-residents of a country are able to exchange that country's currency for other currencies



- Hard currency: usually convertible, strong, stable in comparison to other currencies

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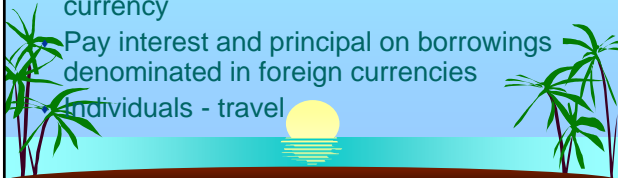
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## Functions of the FE Market

- Make foreign direct investments
- Speculate on foreign exchange movements
- Convert funds from foreign operations (exports, licensing, profits)
- Pay importers, suppliers in foreign currency
- Pay interest and principal on borrowings denominated in foreign currencies
- Individuals - travel



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## Factors Influencing Currency Value

### Economic Factors

1. Balance of Payments
2. Interest Rates
3. Inflation
4. Monetary and Fiscal Policy
5. International Competitiveness
6. Monetary Reserves
7. Government Controls and Incentives
8. Importance of Currency in World

### Political Factors

9. Political Party and Leader Philosophies
10. Proximity of Elections or Change in leadership

### Expectation Factors

11. Expectations
12. Forward Exchange Market Prices

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## Why exchange rates change?

- ♦ Short term
  - rumors, current events, speculation, central bank intervention, imbalances in purchase and sales orders
- ♦ Medium and long-term
  - relative interest rates
  - relative inflation rates
  - trade balance
  - intl. monetary reserves
  - govt. policies (fiscal and monetary)

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## Purchasing Power Parity (PPP) Theorem

- ♦ exchange rates are influenced by inflation rates
- ♦ differences in inflation rates can be used to predict the future expected spot rate
- ♦ compares basket of goods across nations to determine exchange rates
- ♦ assumptions: no transportation costs, no trade barriers, no govt. intervention

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## PPP Theorem Formula

$$\frac{e_{s(t+1)} - e_{s(t)}}{e_{s(t)}} = \frac{I_d - I_f}{1 + I_f}$$

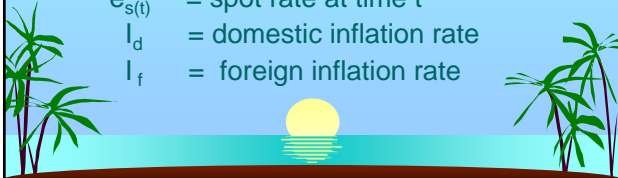
where

$e_{s(t+1)}$  = spot rate at time (t+1)

$e_{s(t)}$  = spot rate at time t

$I_d$  = domestic inflation rate

$I_f$  = foreign inflation rate




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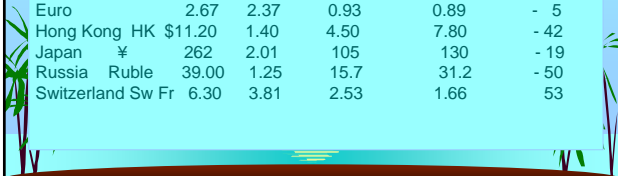
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## The Big Mac Index: PPP, April 2002

**Big Mac Prices**  
Table 9.2

	Price in Local Currency	Price in Dollars	Implied PPP of the Dollar	Actual Exchange Rate 17/04/01	Local Currency % Over(+) or Under(-) Valuation Against Dollar
United States	\$2.49	2.49	---	---	---
Argentina Peso	2.50	0.78	1.00	3.13	-68
Brazil Real	3.60	1.55	1.45	2.34	-38
Canada C \$	3.33	2.12	1.34	1.57	-15
Euro	2.67	2.37	0.93	0.89	-5
Hong Kong HK \$	\$11.20	1.40	4.50	7.80	-42
Japan ¥	262	2.01	105	130	-19
Russia Ruble	39.00	1.25	15.7	31.2	-50
Switzerland Sw Fr	6.30	3.81	2.53	1.66	53




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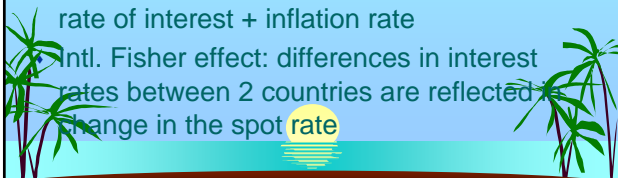
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## Interest Rate Parity (IRT) Theorem

- exchange rates are influenced by interest rates
- differences in interest rates can be used to predict forward rates
- Fisher effect: nominal interest rate = real rate of interest + inflation rate

Intl. Fisher effect: differences in interest rates between 2 countries are reflected in a change in the spot rate




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## IRT Formula

$$\bullet \quad \frac{e_f - e_s}{e_s} = \frac{i_d - i_f}{1 + i_f}$$

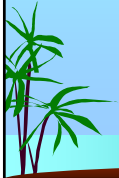
where

$e_f$  = forward rate

$e_s$  = spot rate

$i_d$  = domestic interest rate

$i_f$  = foreign interest rate



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## Currency Convertibility

- **Freely convertible.**
- **Externally convertible.**
- **Not convertible.**
  - Preserve foreign exchange reserves.
    - Service international debt.
    - Purchase imports.
    - Government afraid of **capital flight**.
- **Political decision.**
- **Many countries have some kind of restrictions.**
- **Countertrade.**
  - Barter-like agreements where goods/services are traded for goods/services.
  - Helps firms avoid convertibility issue.



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## The International Monetary System

- The institutional arrangements that countries adopt to govern exchange rates.
- Dollar, Euro, Yen and Pound “float” against each other.
  - Floating exchange rate:
    - ◆ Foreign exchange market determines the relative value of a currency.
- Some countries use other institutional arrangements to fix their currency's value.



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Require some degree of government intervention.

- Some countries use:
  - Pegged exchange rate.
    - ◆ Value of currency is fixed relative to a reference currency.
  - Dirty float.
    - ◆ Hold currency value within some range of a reference currency.
  - Fixed exchange rate.
    - ◆ Set of currencies are fixed against each other at some mutually agreed upon exchange rate.

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### The Gold Standard

- Pegging currencies to gold and guaranteeing convertibility
- Roots in mercantile trade.
- Inconvenient to ship gold, changed to paper - redeemed for gold.
- Seeking a "balance of trade" equilibrium.

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### The Gold Standard

- countries pegged their currency to gold by agreeing to exchange a give amount of money for an ounce of gold
- \$ 1 = 23.22 grains of gold
- the exchange rate is determined based on how much a gold a unit each currency would buy
- a powerful mechanism to pull trade imbalances back into equilibrium
- system broke down when countries devalued currencies

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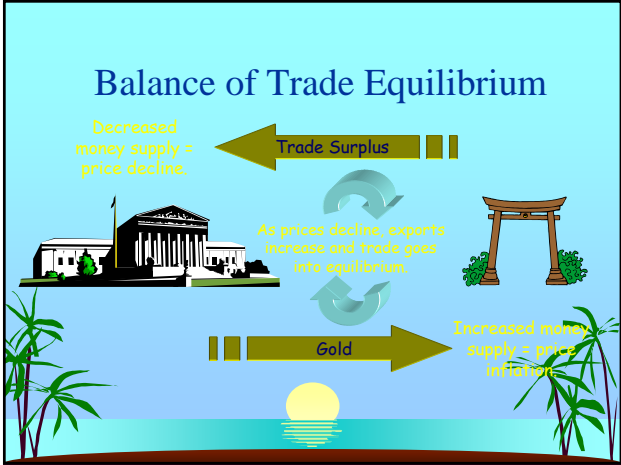
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### Period Between the Wars: 1918-1939

- Countries abandoned gold standard at start of WWI.
- Costs of war led countries to print money resulting in inflation.
  - U.S. ('19), Great Britain ('25), & France('28) returned to gold standard at end of war.
    - ◆ Britain used old rate and priced exports out of the market.
    - ◆ U.S. did same. Then changed gold/\$ ratio devaluing the dollar to increase exports.
      - Other countries did same. No faith in currencies.
      - Run on countries gold reserves.
- 1939 - End of gold standard.

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### Bretton Woods

- 1944:
  - 44 countries meet in New Hampshire.
  - Fixed exchange rates deemed desirable.
    - ◆ Agree to peg currencies to US dollar that is convertible to gold at \$35/oz.
  - Promise not to devalue currency for trade purposes and will defend currencies.
  - Created:
    - ◆ World Bank
    - ◆ International Monetary Fund.

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## Fixed Exchange Rates - Bretton Woods System

- 2 multinational institutions IMF & World Bank created to monitor intl. envt.
- US \$ pegged & convertible to gold & other currencies set rates relative to \$
- Greater monetary discipline - IMF approval needed for devaluations > 10%

IMF helped with S.T. loans to countries to stabilize their currencies

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## The Role of the IMF

- Want to avoid problems following WWI.

### – Discipline:

- ◆ Fixed rate imposes discipline:
  - Need to maintain rate stops competitive devaluations.
  - Imposes monetary discipline, curtailing inflation.

### – Flexibility:

- ◆ Lending facility:
  - Lend foreign currencies to countries having balance-of-payments problems.
- ◆ Adjustable parities:
  - Allow countries to devalue currencies more than 10% if B of P was in 'fundamental disequilibrium'.

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## World Bank (IBRD)

- Major purpose to provide funds to help in the development of LDCs
- Lends money at generous interest rates to countries to improve infrastructure, education, population control, etc.

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## The Role of the World Bank

- ♦ International Bank for Reconstruction and Development (IBRD).
- ♦ Rebuild Europe's war-torn economies.
  - Overshadowed by the Marshall Plan.
- ♦ Turns to 'development'.
  - Lending money to Third World nations
    - ◆ Agriculture.
    - ◆ Education.
    - ◆ Population control.
    - ◆ Urban development.

IBRD raises money in bond market and lends at 'market rate'.

International Development Agency raises money through subscriptions and lends to very poor countries.

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## Collapse of the Fixed Exchange Rate System

- ♦ Collapsed in 1973.
  - Pressure to devalue dollar led to collapse.
    - ◆ President Johnson financed both the Great Society and Vietnam by printing money.
      - High inflation.
      - High spending on imports.
    - ◆ President Nixon took dollar off gold standard and kept 10% import tax.
    - ◆ Countries agreed to revalue their currencies against the dollar.
  - Bretton Woods fails when key currency (dollar) is under speculative attack.
- ♦ Now have a managed-float system.

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## Floating Exchange Rates

- ♦ Bretton Woods collapsed when US. ran high deficits and had high inflation
- ♦ Jamaica Agreement
  - end of gold as a reserve asset
  - start of floating exchange rates in 1973
- ♦ Free float - market forces operate
- ♦ Managed or Dirty Float - govt. intervention to support weak currency
- ♦ smooth adjustment of trade imbalances
- ♦ countries have control over monetary policy

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## Fixed versus Floating Exchange Rates

- **Floating:**
  - Monetary policy autonomy.
    - ◆ Restores control to government.
  - Trade balance adjustments.
    - ◆ Adjust trade
- **Fixed:**
  - Monetary discipline.
  - Speculation.
    - ◆ Limits speculators.
  - Uncertainty.
    - ◆ Predictable rate movements.
  - Trade balance adjustments.
    - ◆ Argue no linkage between exchange rates and trade.
      - Linkage between savings and investment.

Which system is better?  
Evidence is unclear.

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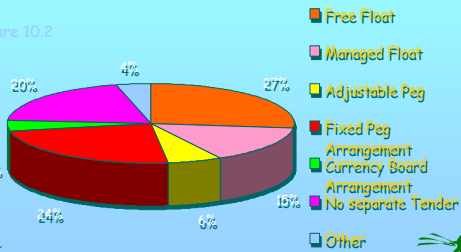
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## IMF Members' Exchange Rate Policies, 2000

Figure 10.2




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