

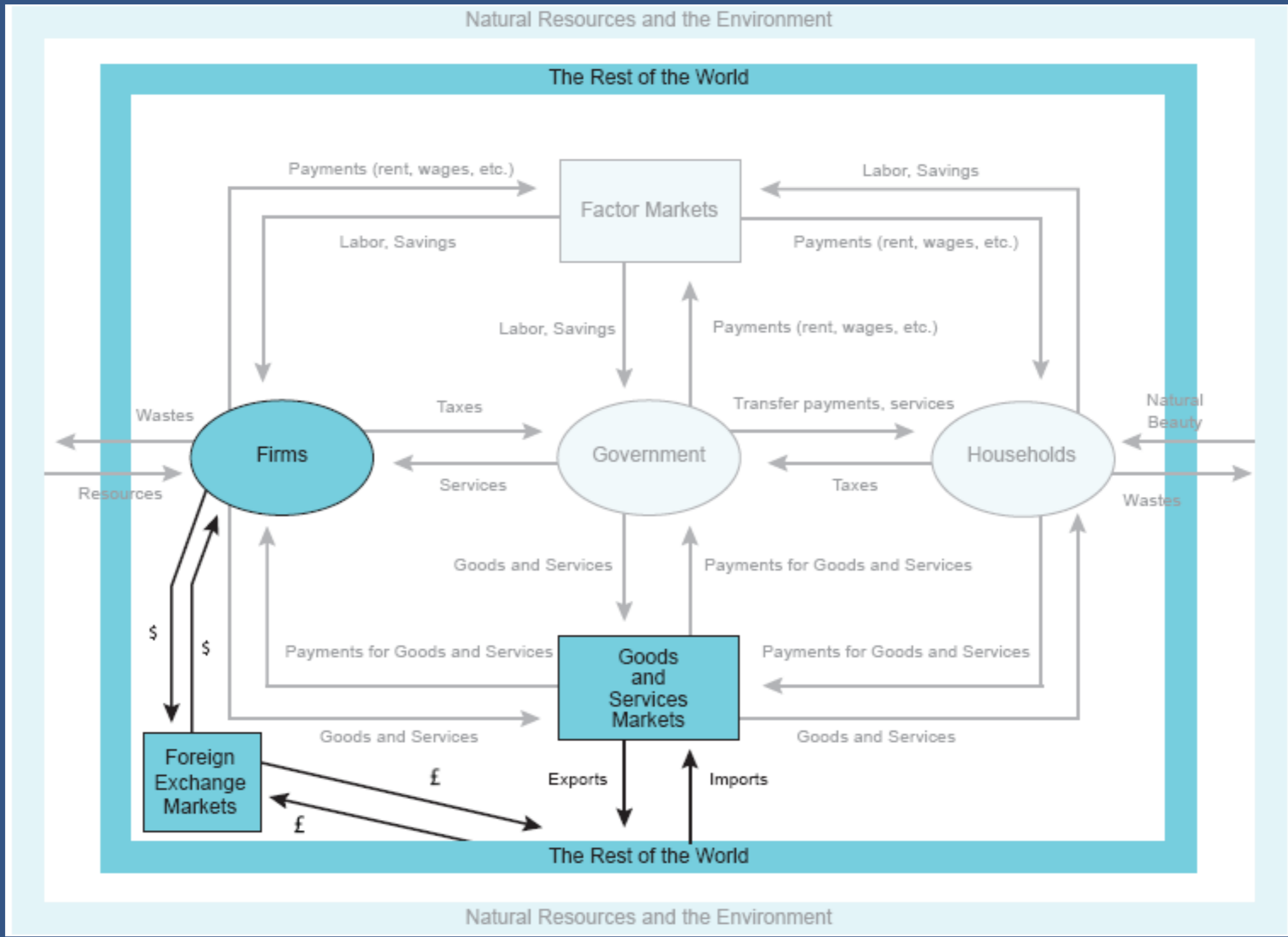
INTERNATIONAL FINANCE AND EXCHANGE RATES

CHAPTER 16

CHAPTER OUTLINE

- International Financial Transactions
- Foreign Exchange Markets
- Alternative Foreign Exchange Systems

YOU ARE HERE



CURRENCY

- In the last set of lecture notes we looked at trade between nations
- We talked about trading burgers for buns and apples for coffee, but of course that is not what really happens
- Usually we sell apples for money and use the money to buy coffee
- However, this is complicated in international trade because there are different currencies
- In general people don't like to just hold foreign currency
 - Its not very useful to have Yuan in Brazil
 - It doesn't earn any interest just sitting there-would rather invest it or spend on other stuffy
- The Balance of Payments keeps track of the accounting

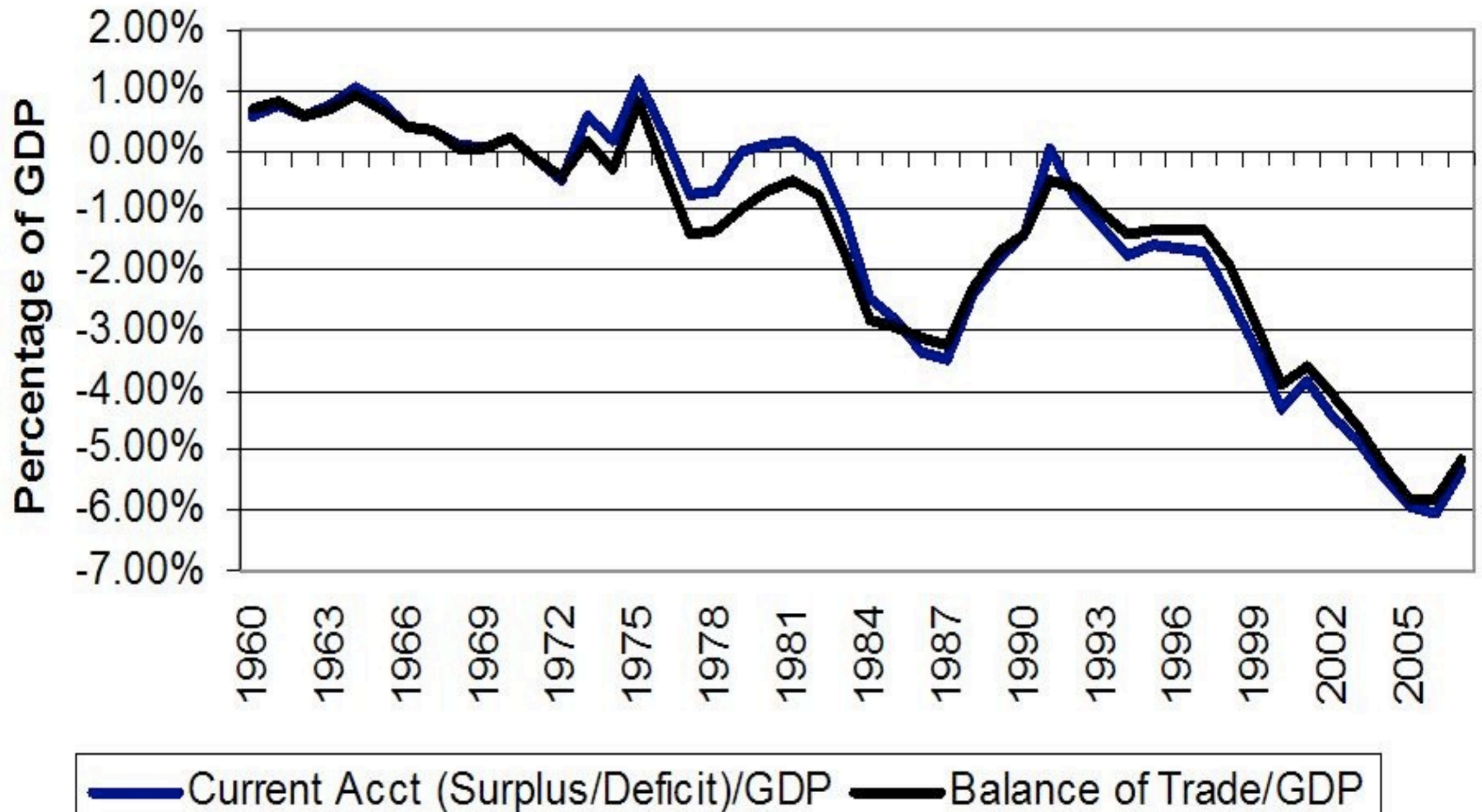
BALANCE OF PAYMENTS

- **Balance of Payments:** the accounting system for how money moves between countries to facilitate the purchase of goods, services, financial instruments, and physical investments.
- **Current Account:** The portion of the Balance of Payments accounting that represents that impacts of trade, short-term investment payments, and American payments of foreign taxes, foreign payments of American taxes, and the net transfer of private money.
- The **Capital Account** represents the changes in holding of longer term financial and physical assets by citizens of one country in another country.

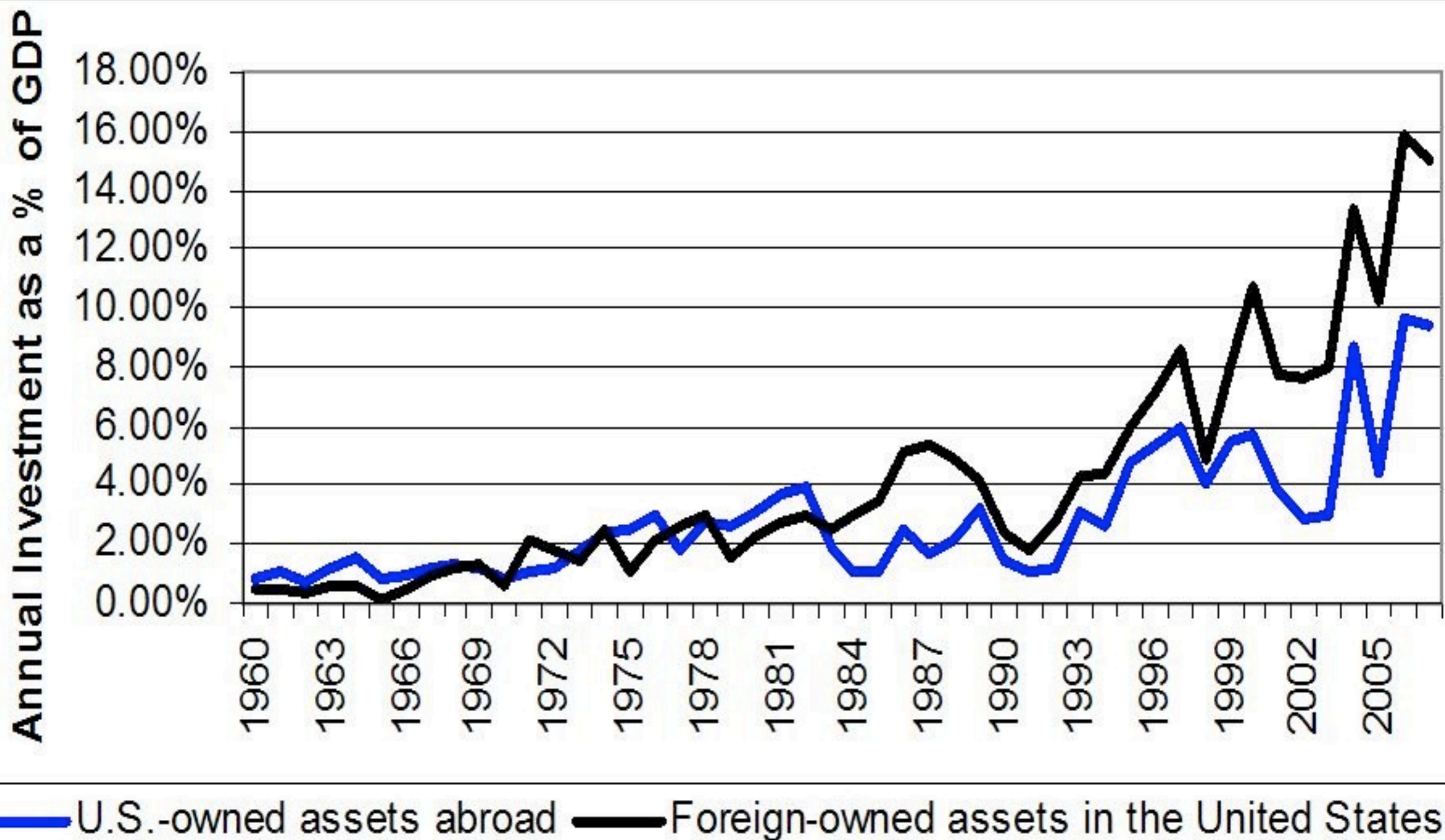
BALANCE OF PAYMENTS UNITED STATES, 2007

Major Accounting Item	Sub Accounting Item	Sub Acct component	Component Amount	Sub Acct Balance	Balance
Current Account	Balance of Trade	Exports	\$1,645,726	-\$700,258	-\$731,214
		Imports	\$2,345,984		
	Balance of Short-term Investment Income	Income to the US	\$817,779	\$81,749	
		Payments from the US	-\$736,030		
	Net Transfers (taxes, private payments)				
Capital Account	Change in the Ownership of Assets	US owned assets abroad	\$1,289,854	\$767,849	-\$731,214
		Foreign owned assets in the US	\$2,057,703		
	Statistical Discrepancy & Net Derivatives				

CURRENT ACCOUNT MIRRORS THE BALANCE OF TRADE



FOREIGN PURCHASES OF US ASSETS & US PURCHASES OF FOREIGN ASSETS



TRADE REQUIRES CURRENCY

- Trade between countries is beneficial.
- International trade requires that the currency of the trading partners be exchanged.
- The market where people come to trade currencies is called the **foreign exchange market**.
- E.g. the production and export of a radio can require several currency transactions.

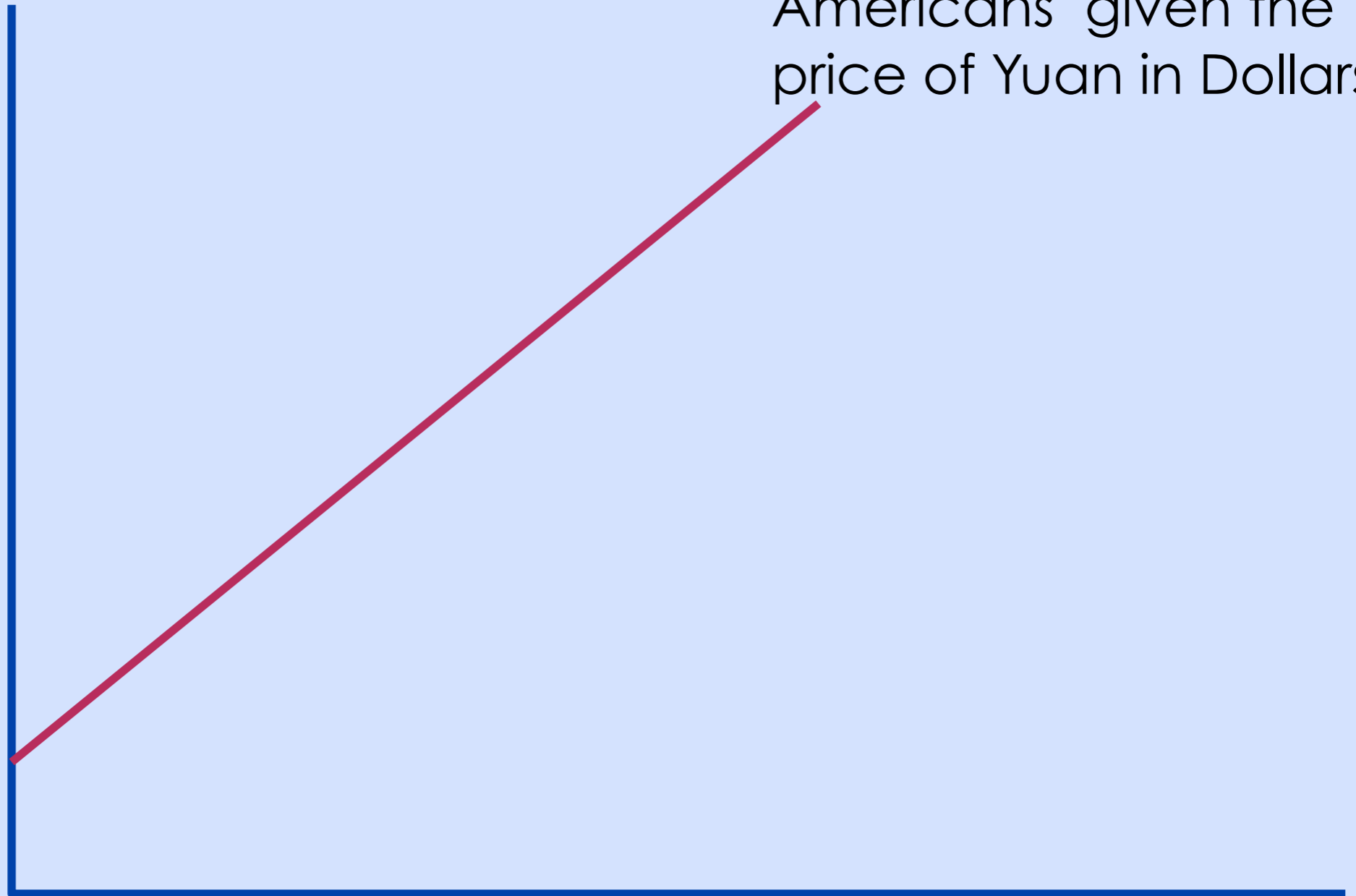
FOREIGN EXCHANGE MARKETS

- The demand for a currency (say the dollar) is also the supply of the other currency (say the yen).
- The supply for a currency (say the dollar) is also the demand of the other currency (say the yen).

Price of
Yuan in
U.S.
dollars

Quantity of Yuan held by
Americans

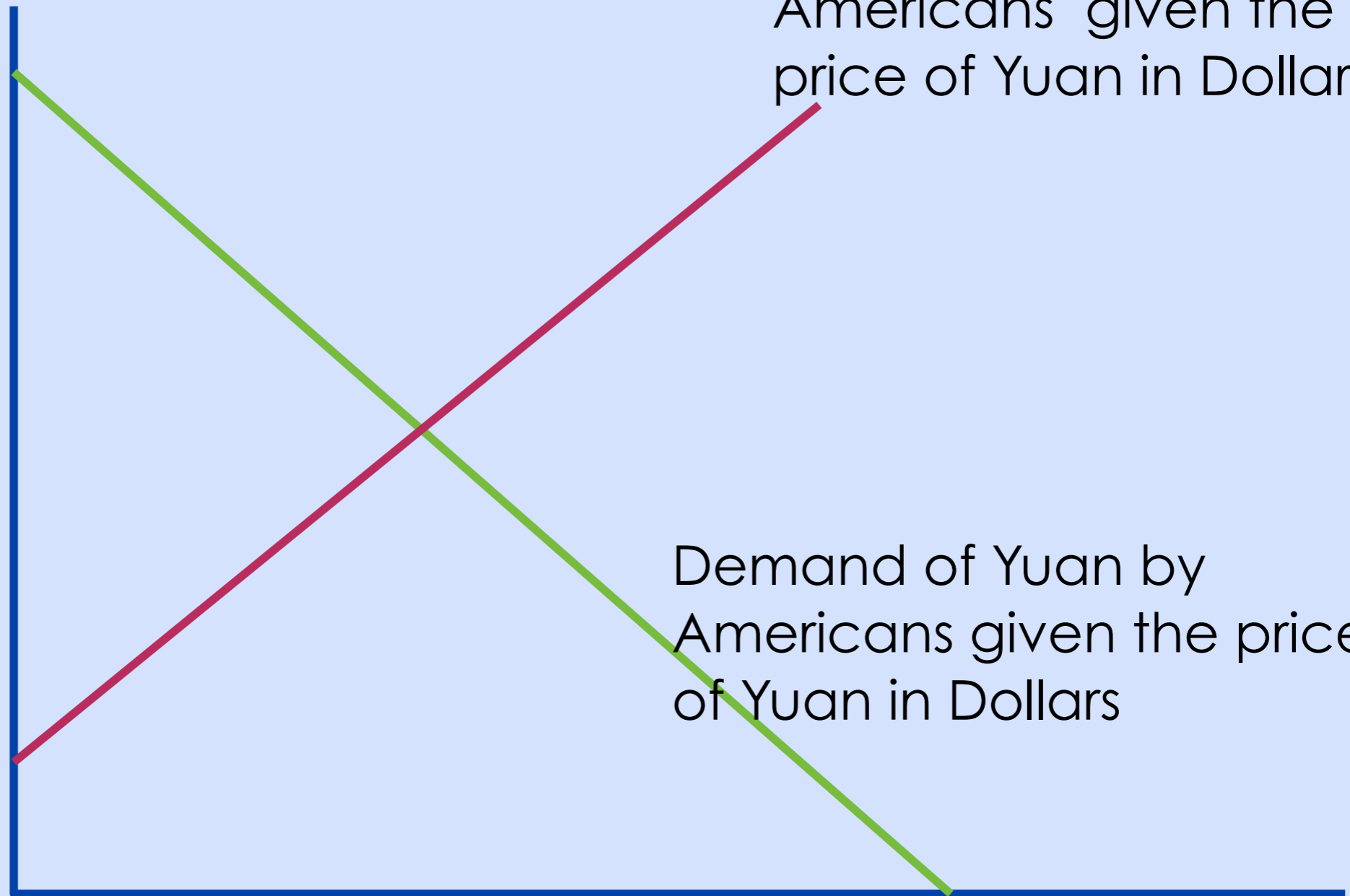
Price of Yuan in U.S. dollars



Supply of Yuan to Americans given the price of Yuan in Dollars

Quantity of Yuan held by Americans

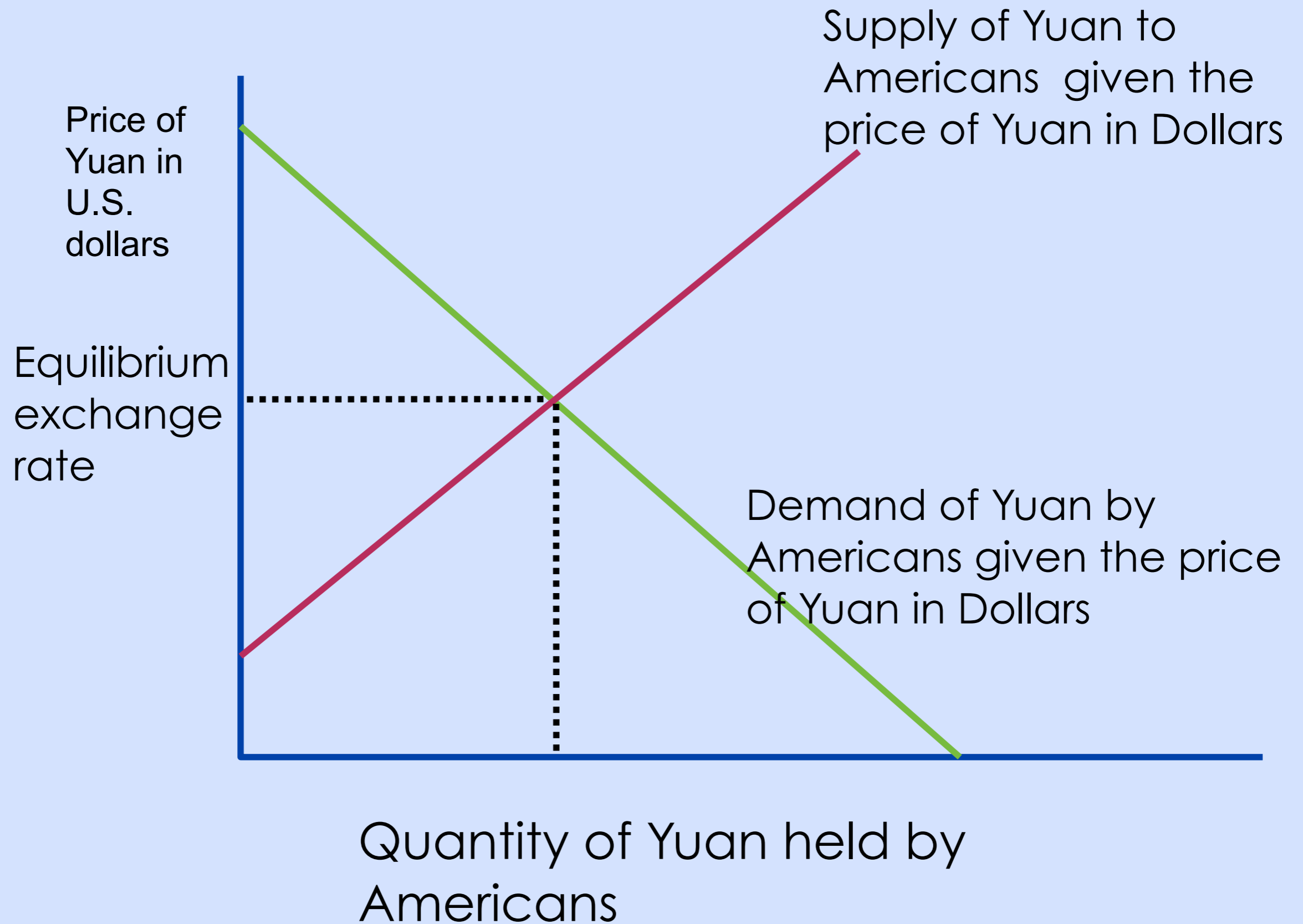
Price of Yuan in U.S. dollars

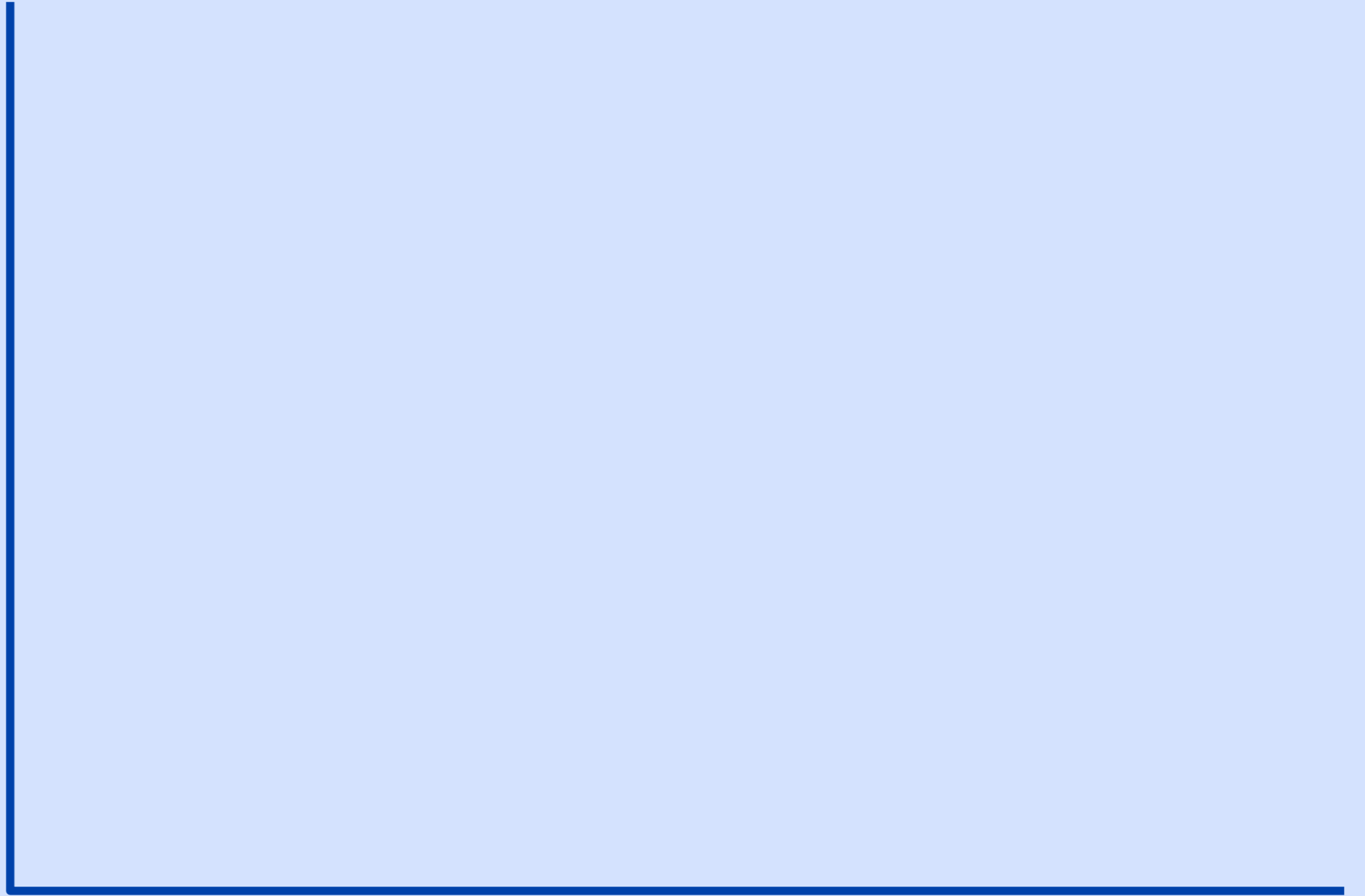


Supply of Yuan to Americans given the price of Yuan in Dollars

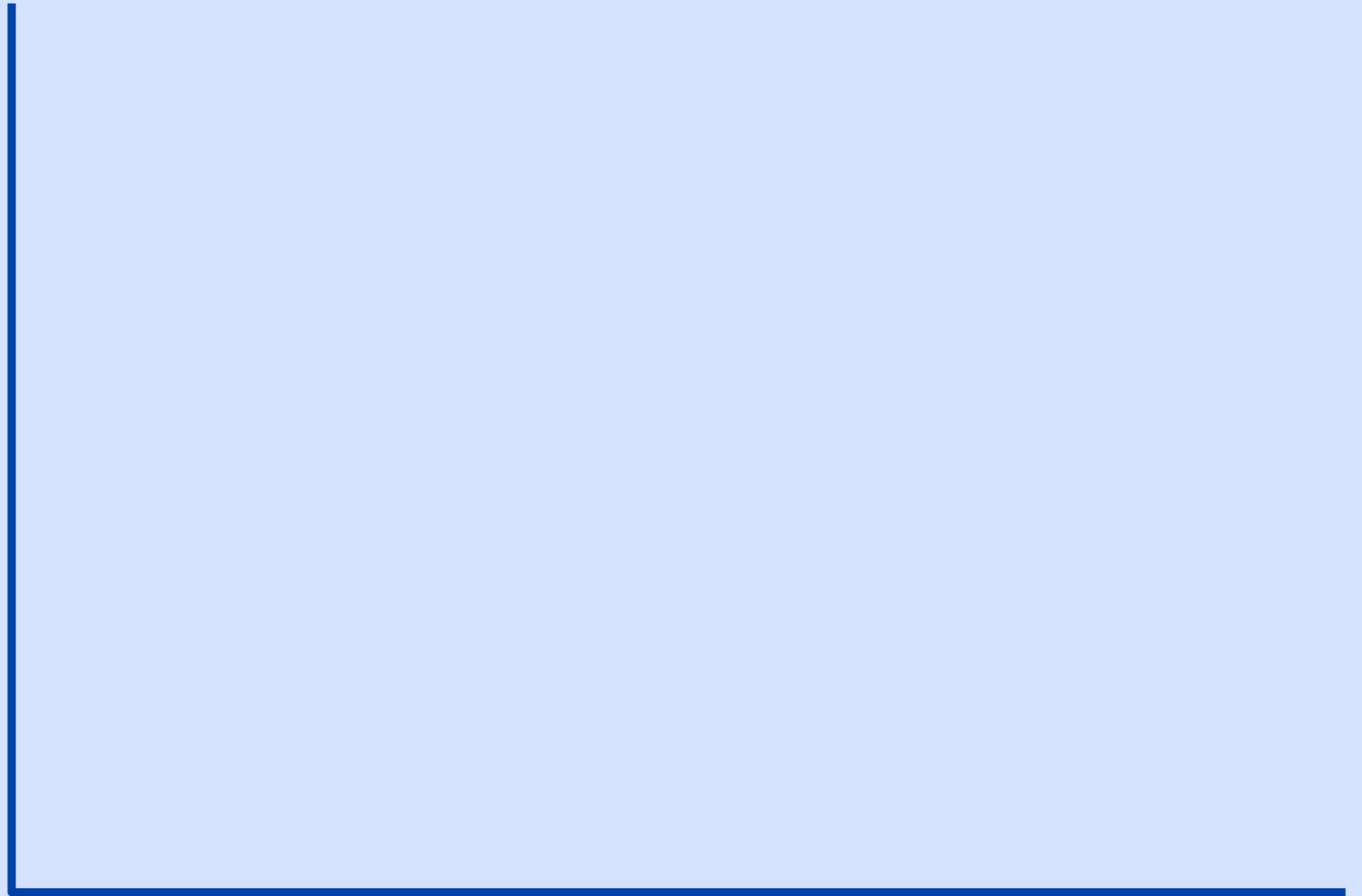
Demand of Yuan by Americans given the price of Yuan in Dollars

Quantity of Yuan held by Americans





We Could do this Completely
the other way around and it
won't matter



We Could do this Completely
the other way around and it
won't matter

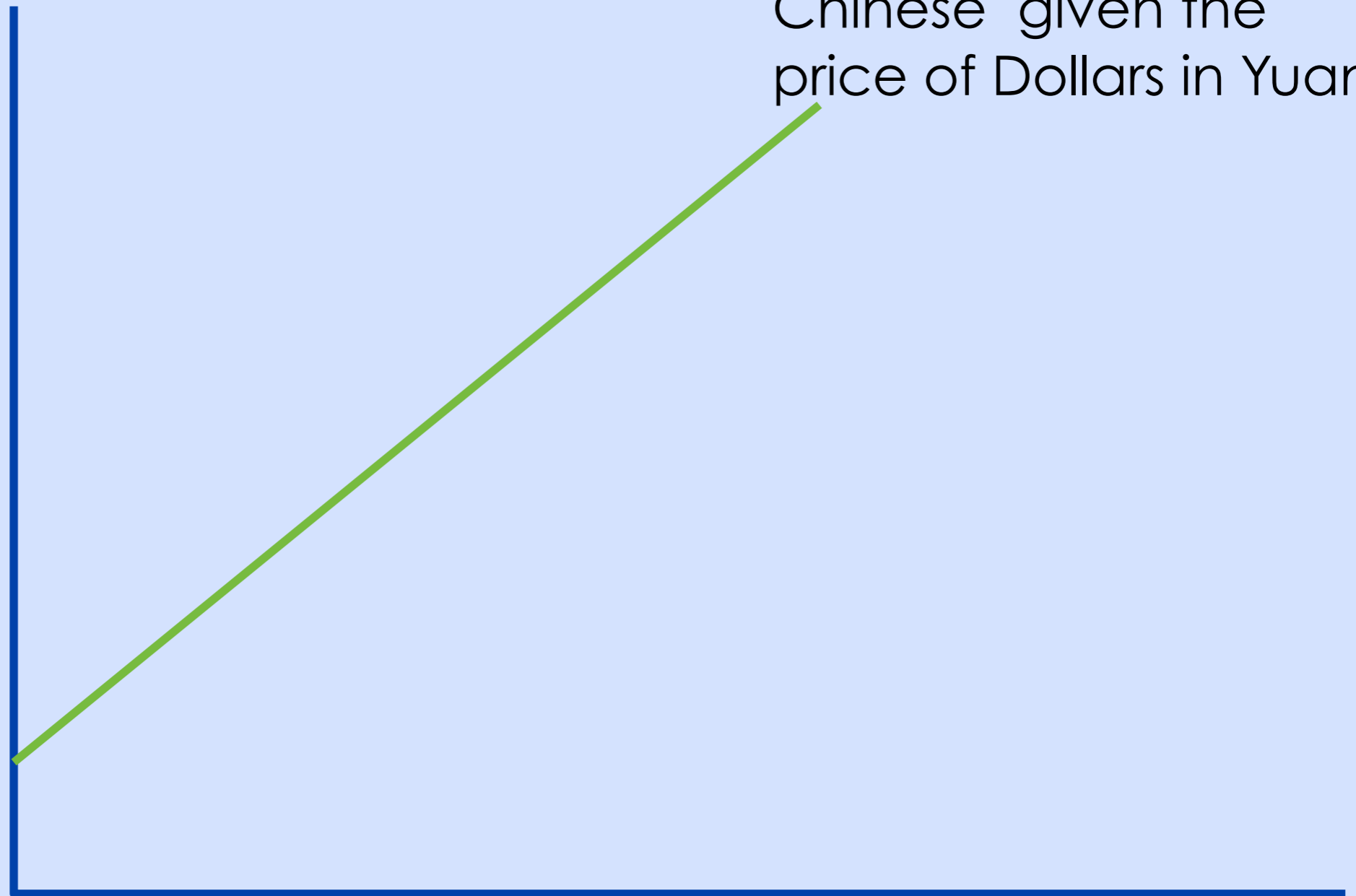
Price of
U.S.
dollars
in Yuan



Quantity of Dollars held
by Chinese

We Could do this Completely
the other way around and it
won't matter

Price of
U.S.
dollars
in Yuan



Supply of Dollars to
Chinese given the
price of Dollars in Yuan

Quantity of Dollars held
by Chinese

We Could do this Completely
the other way around and it
won't matter

Price of
U.S.
dollars
in Yuan

Supply of Dollars to
Chinese given the
price of Dollars in Yuan

Demand of Dollars by
Chinese given the price of
Dollars in Yuan

Quantity of Dollars held
by Chinese

We Could do this Completely the other way around and it won't matter

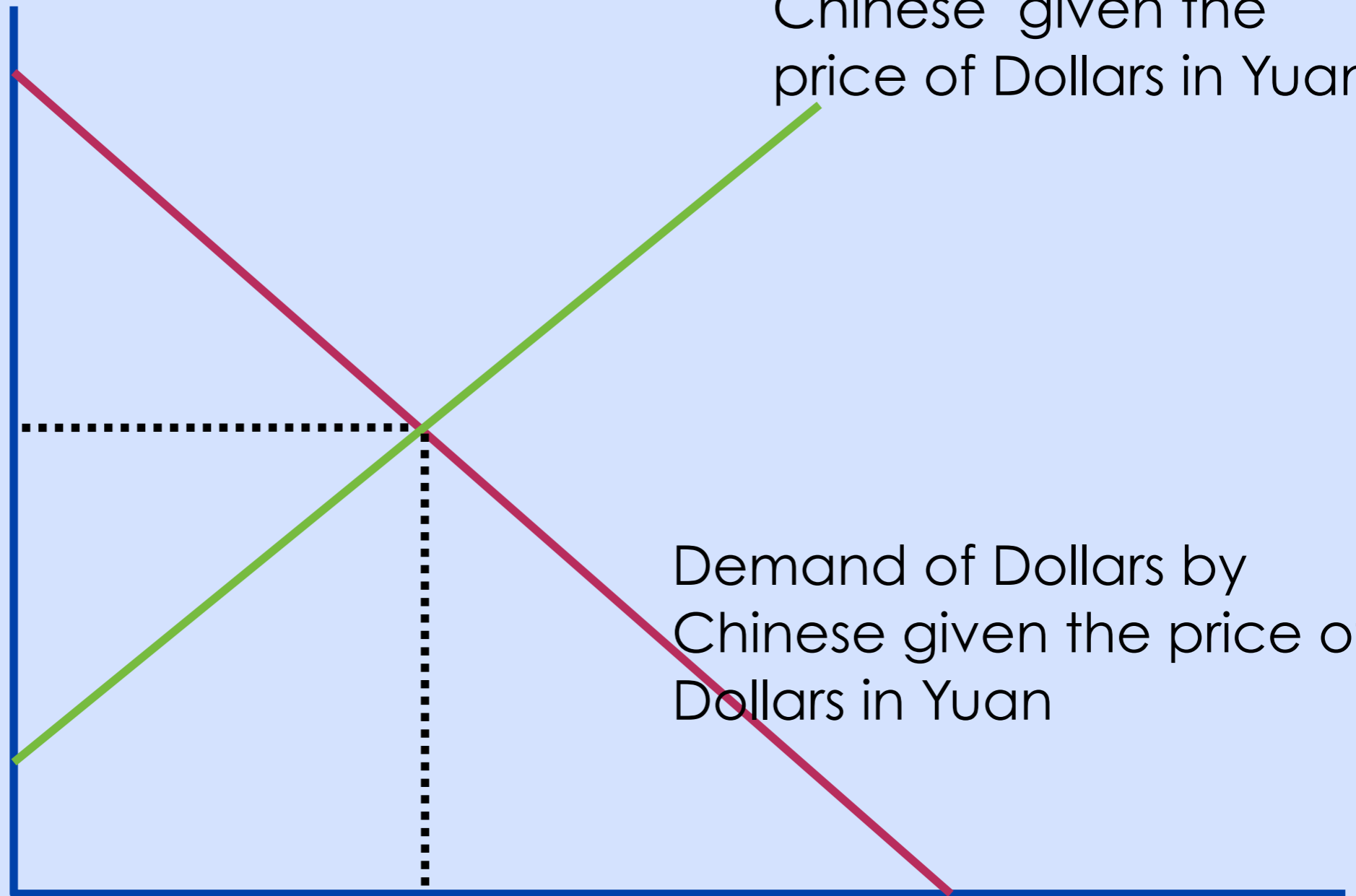
Price of U.S. dollars in Yuan

Equilibrium exchange rate

Supply of Dollars to Chinese given the price of Dollars in Yuan

Demand of Dollars by Chinese given the price of Dollars in Yuan

Quantity of Dollars held by Chinese













EXCHANGE RATE CHANGES

So what happens when exchange rate changes?

- Suppose the Dollar appreciates relative to the Euro-that means we can get more Euros for our dollar
- This decreases the price of European goods relative to U.S. goods so:
 - Imports should rise
 - Exports should fall

VARIOUS EXCHANGE RATES

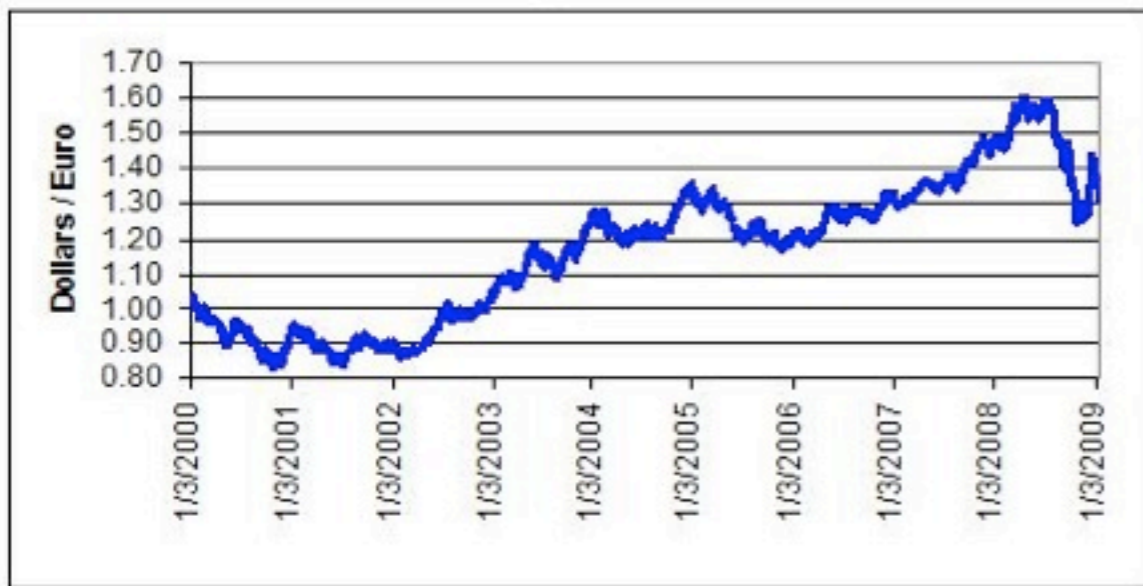
 USD	 GBP	 CAD	 EUR	 AUD
 1	1.58043	0.98906	1.3828	1.03178
 0.632738	1	0.625816	0.87495	0.65285
 1.01106	1.59791	1	1.39809	1.04319
 0.72317	1.14292	0.715259	1	0.746156
 0.969193	1.53174	0.95859	1.3402	1

Wednesday, October 19, 2011

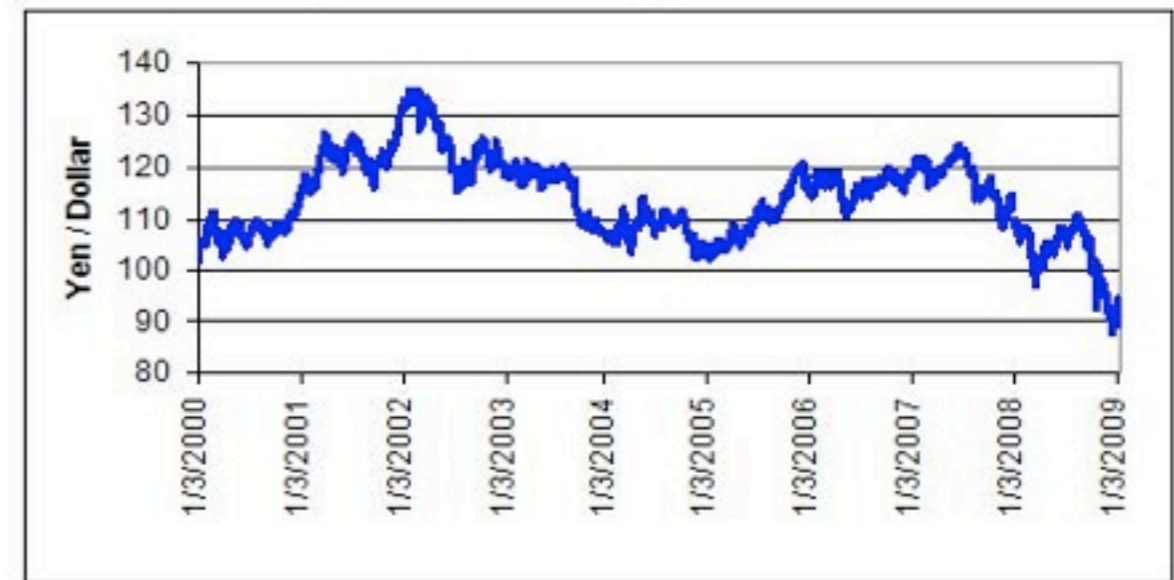
The Way to Read this is 1 US Dollar buys 0.72 Euros

VARIOUS EXCHANGE RATES

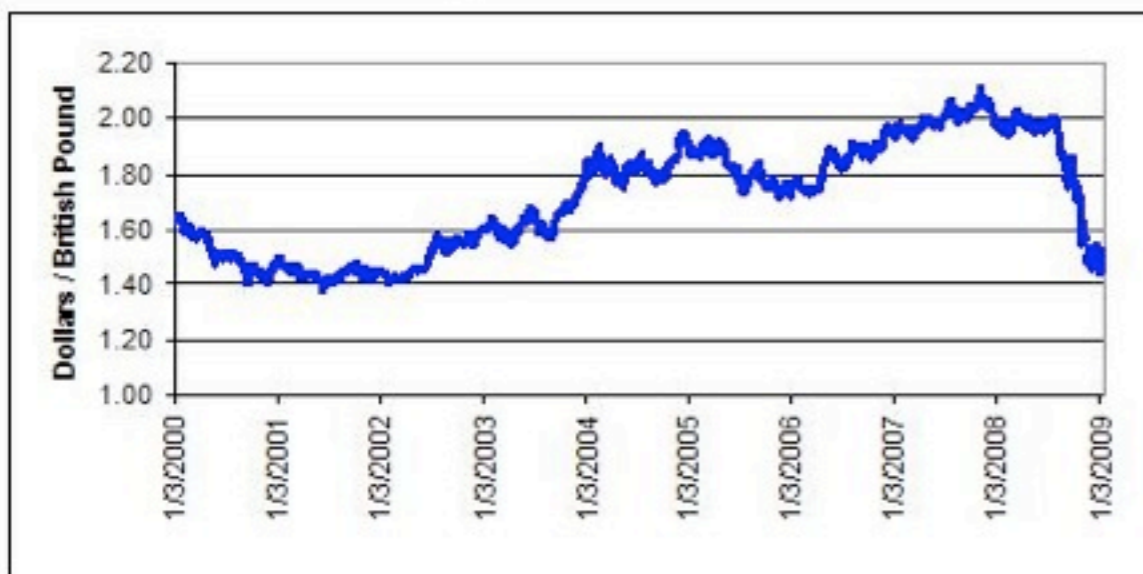
US Dollar per Euro



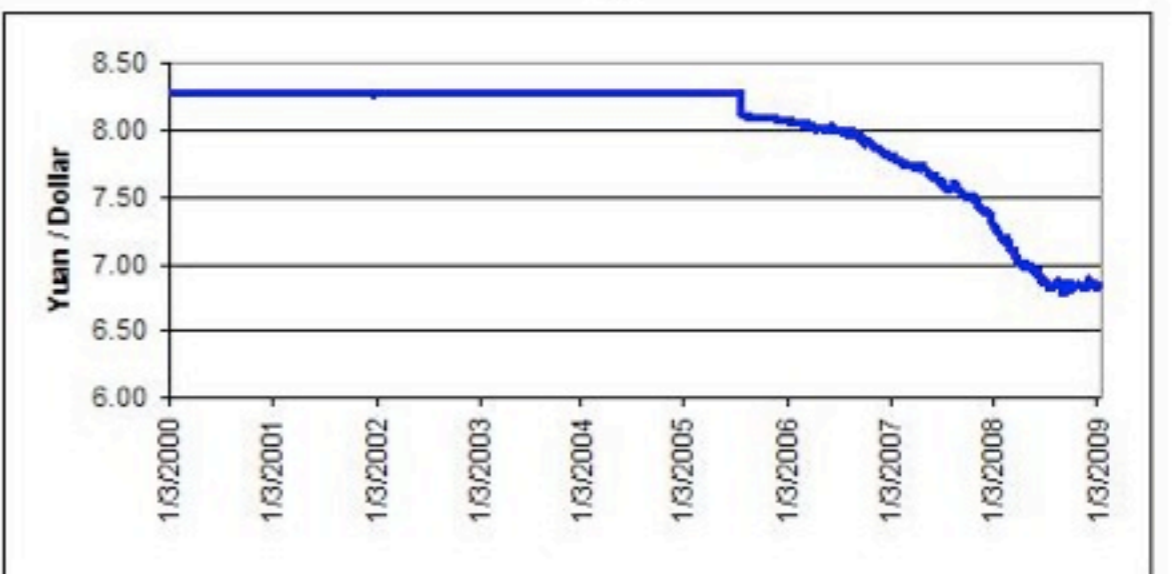
Japanese Yen per US Dollar



US Dollar per British Pound



Chinese Yuan per US Dollar



ALTERNATIVE FOREIGN EXCHANGE SYSTEMS

- **Floating exchange rate system**: a system whereby markets determine the value of a currency relative to all other currencies.
- **Fixed exchange rate system** : a system whereby a government sets the value of a currency relative to all other currencies and uses its reserve of foreign currencies or gold to maintain the exchange rate.
- **Managed Float exchange rate system**: a system whereby governments decide the range of exchange rates they will allow the market to create, and act only when either the top end or the bottom end of that range is breached.