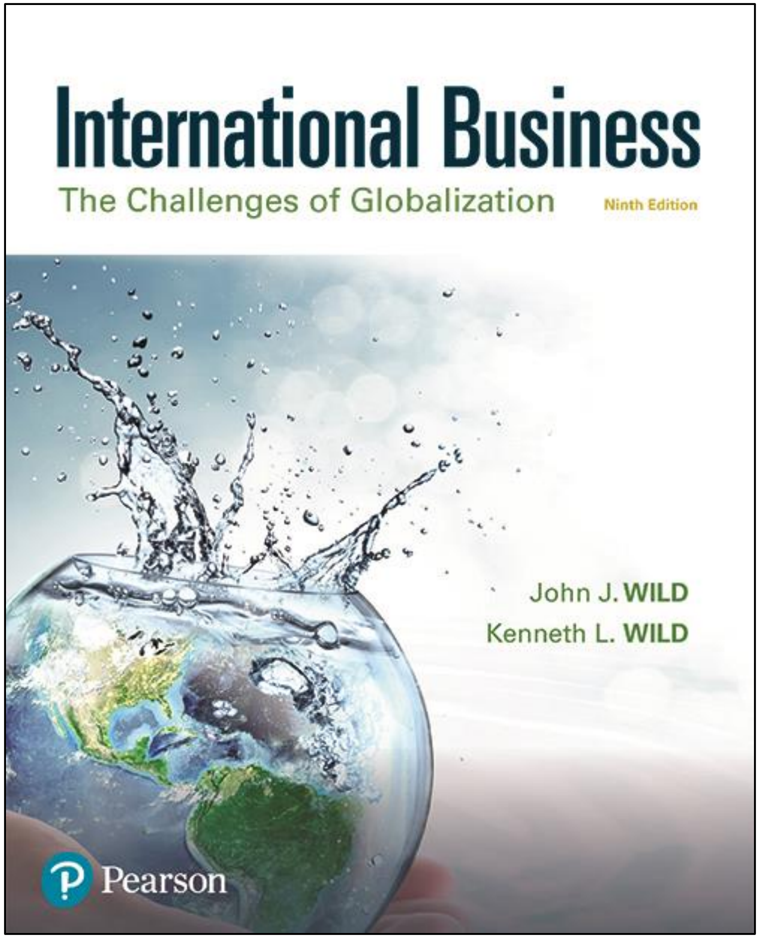
International Business: The Challenges of Globalization

Ninth Edition



Chapter 10

International Monetary System

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Learning Objectives

10.1 Describe the importance of exchange rates to business activities.

10.2 Outline the factors that help determine exchange rates.

10.3 Explain attempts to construct a system of fixed exchange rates.

10.4 Describe efforts to create a system of floating exchange rates.

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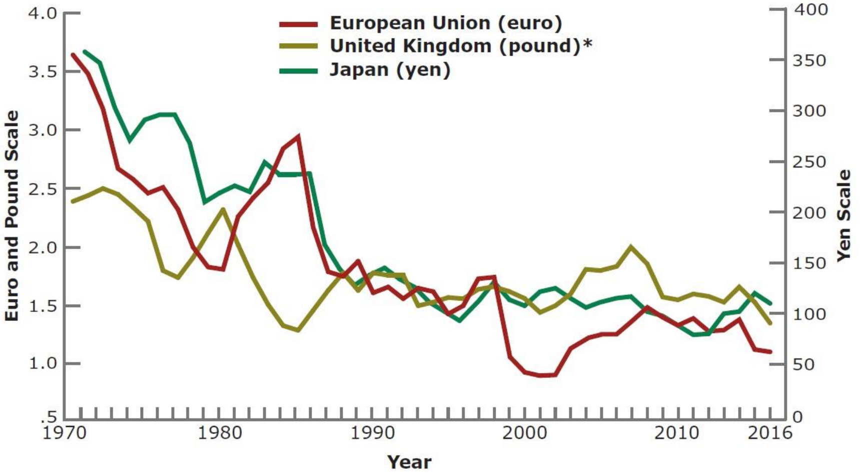
Importance of Exchange Rates (1 of 4)

- **Devaluation:**
  - Intentionally lowering the value of a nation’s currency
- **Revaluation:**
  - Intentionally raising the value of a nation’s currency

Figure 10.1 Exchange Rates of Major World Currencies



*Value is U.S. dollars per pound.

Prior to 1999, data for the Euro represents the German mark.

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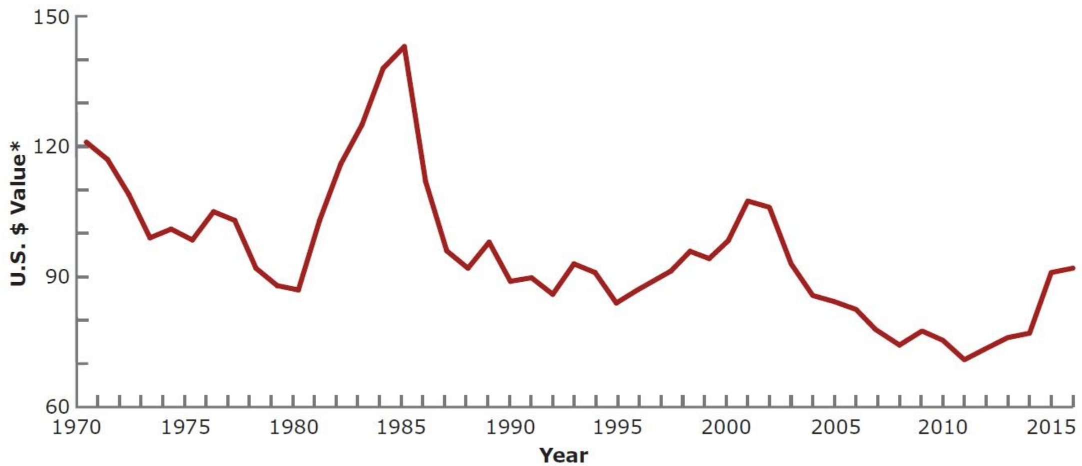
Importance of Exchange Rates (2 of 4)

Desire for Predictability and Stability

- **Stable exchange rates**
  - Improve accuracy of forecasts and financial planning
- **Predictable exchange rates**
  - Reduce surprises of unexpected rate changes



* Multilateral trade-weighted value of the U.S. dollar. (March 1973 = 100)

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Importance of Exchange Rates (3 of 4)

Efficient versus Inefficient Market View

Efficient Market View

- View that prices of financial instruments reflect all publicly available information at any given time

Inefficient Market View

- View that prices of financial instruments do not reflect all publicly available information

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Importance of Exchange Rates (4 of 4)

Forecasting Techniques

Fundamental Analysis

– Technique that uses statistical models based on fundamental economic indicators to forecast exchange rates

Technical Analysis

– Technique that uses charts of past trends in currency prices and other factors to forecast exchange rates

Forecasting Difficulties

- Unexpected events
- Human error
- Regulatory changes

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Quick Study 1

1. For a country with a currency that is weakening (valued low relative to other currencies), what will happen to the price of its exports and the price of its imports?
2. Unfavorable movements in exchange rates can be costly for businesses, so managers prefer that exchange rates be what?
3. The view that prices of financial instruments reflect all publicly available information at any given time is called what?

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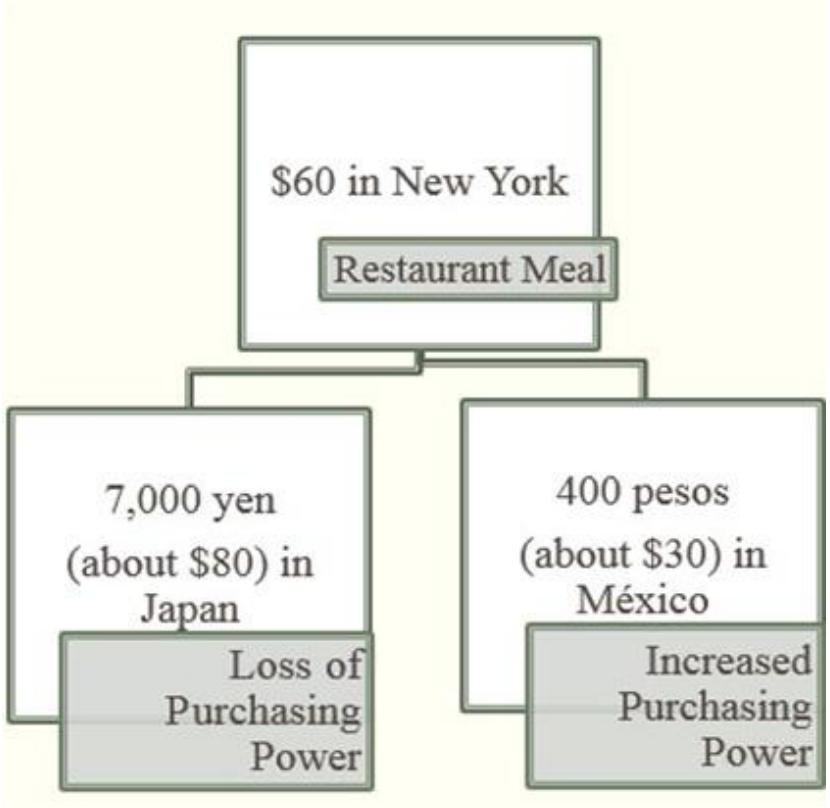
What Factors Determine Exchange Rates? (1 of 3)

Law of One Price

- Principle that an identical item must have an identical price in all countries when the price is expressed in a common currency



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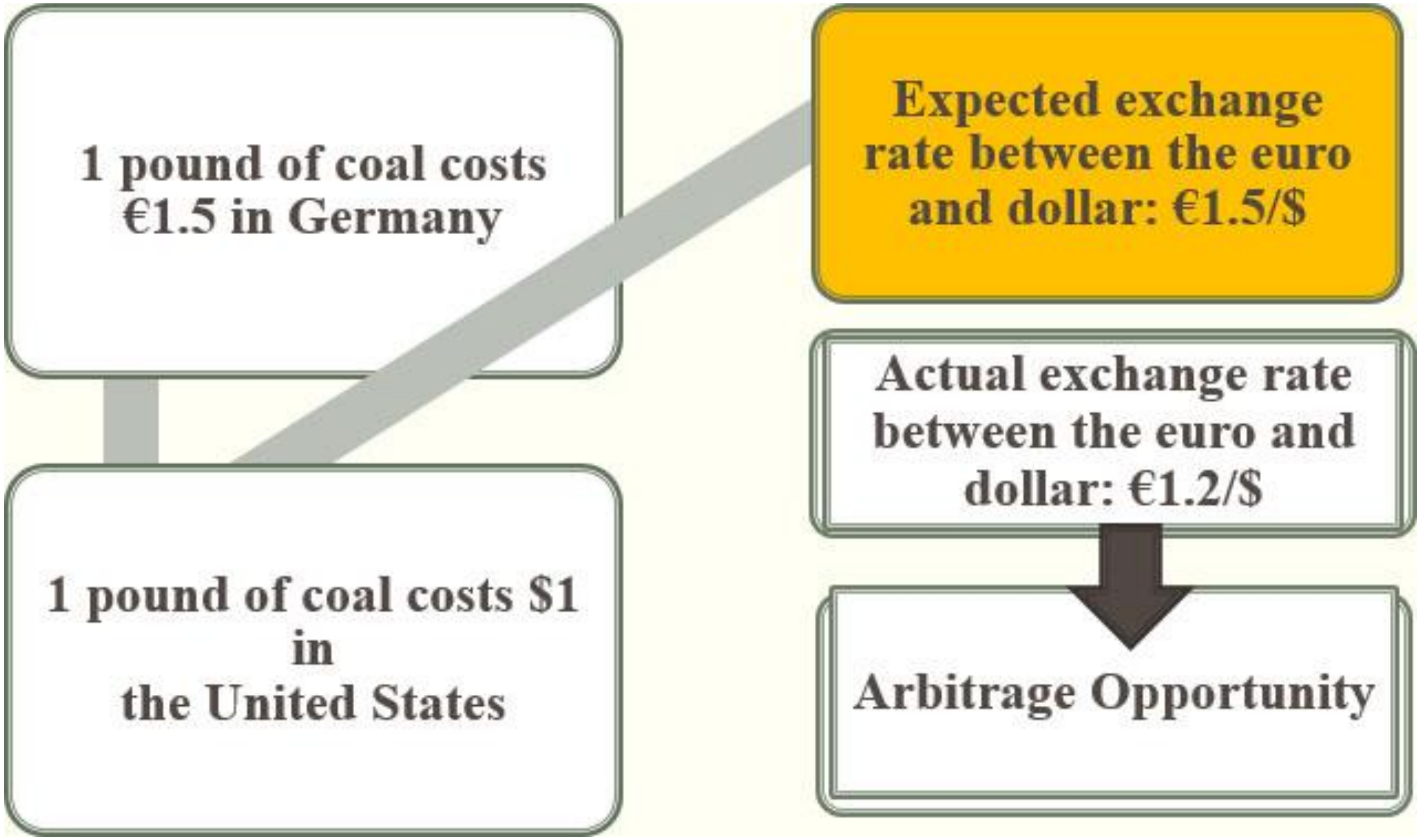
What Factors Determine Exchange Rates? (2 of 3)



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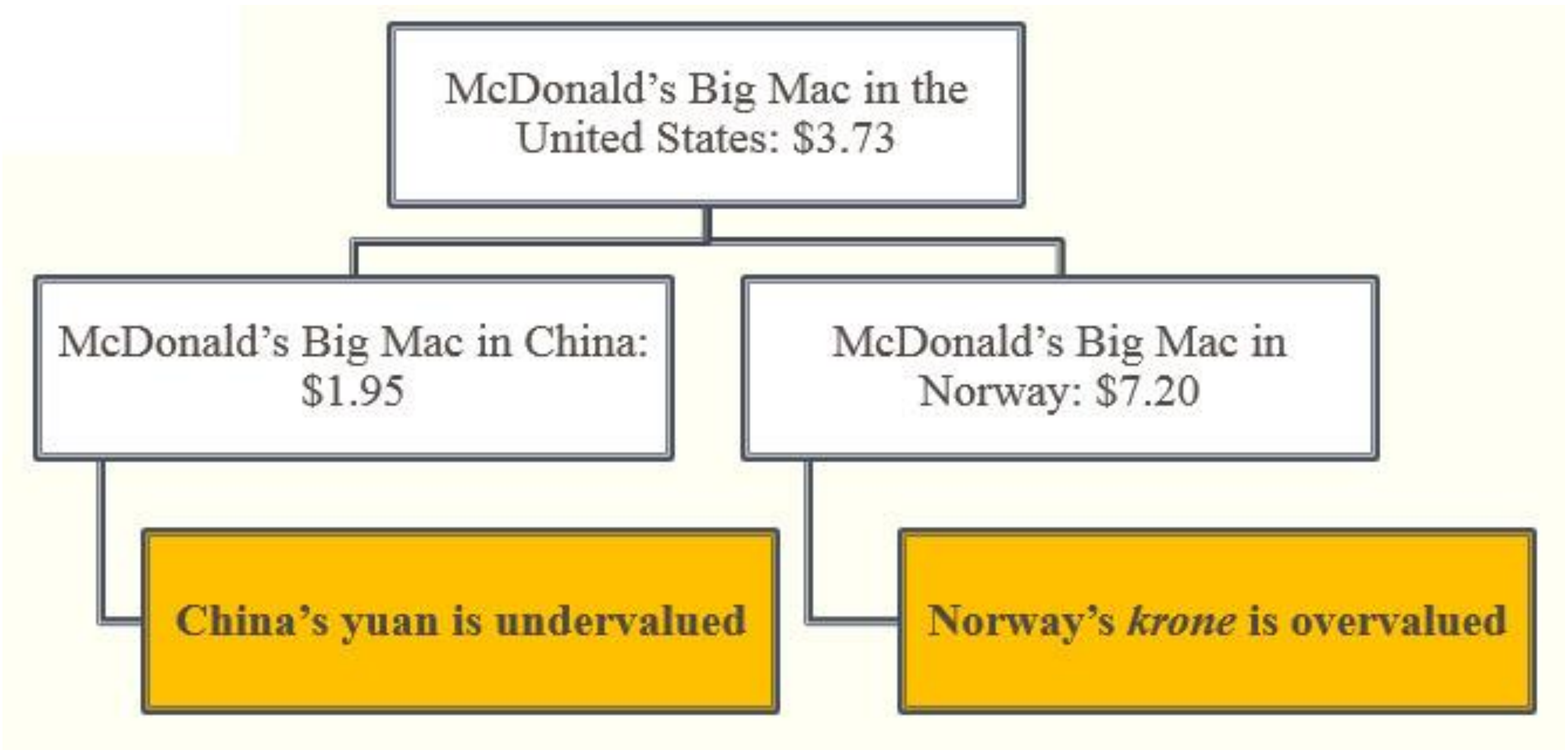
What Factors Determine Exchange Rates? (3 of 3)

Law of One Price: McCurrency

- “Big Mac Index”



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Purchasing Power Parity (PPP)

- PPP can be interpreted as the exchange rate between two nations' currencies that is equal to the ratio of their price levels.

650 baht in Thailand will buy a bag of groceries that costs $30 in the United States.

Exchange rate:
41.45 *baht* =1 dollar (**41.45 baht/$)**

PPP rate of the baht=650 ÷ 30 =
21.67 baht per dollar (**21.67/$)**

Thai GNP/capita = 122,277 baht ($2,950)

Thailand's GNP per capita at PPP :
122,277 ÷ 21.67 = $5,643

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Purchasing Power Parity (1 of 4)

Role of Inflation

Inflation erodes people's purchasing power.

Money Supply

- Monetary policy directly affects interest rates and money supply
- Fiscal policy indirectly affects taxes and spending

Employment

- High employment raises wages, which are embodied in consumer prices

Interest Rates

- High interest rates lower borrowing and spending, which lowers inflation

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Purchasing Power Parity (2 of 4)

How Exchange Rates Adjust to Inflation

- Exchange rates adjust to different rates of inflation in different countries.
  - Necessary to maintain PPP between nations

Exchange rate at the beginning of the year:

Eb = 8 pesos/$

Inflation in Mexico ($\mathbf{i_1}$ = 20%)

Inflation in USA ($\mathbf{i_2}$ = 3%)

- Exchange rate (E_e) at the end of the year

$$E_e = E_b(1 + i_1)/(1 + i_2) = 9.3\text{pesos/\$}$$

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Purchasing Power Parity (3 of 4)

Role of Interest rates

How do interest rates affect exchange rates between two currencies?

Two Types

- Real interest rates
- Nominal interest rates

Fisher Effect

- Nominal interest rate = real interest rate + inflation rate

International Fisher Effect

- Principle that a difference in nominal interest rates supported by two countries' currencies will cause an equal but opposite change in their spot exchange rates

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Purchasing Power Parity (4 of 4)

Evaluating PPP

- Impact of Added Costs
  – PPP assumes no transportation costs.
- Impact of Trade Barriers
  – PPP assumes no barriers to international trade.
- Impact of Business Confidence and Psychology
  – PPP overlooks the human aspect of exchange rates.

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Quick Study 2

1. The principle that an identical item must have an identical price in all countries when price is expressed in a common currency is called what?
2. A unique aspect of purchasing power parity in the context of exchange rates is that it is only useful when applied to what?
3. What is the impact on purchasing power when growing demand for products outstrips a stagnant supply?
4. What factors influence the power of purchasing power parity to accurately predict exchange rates?

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Fixed Exchange Rate Systems

International Monetary System

- Collection of agreements and institutions that govern exchange rates

Fixed Exchange Rate System

- System in which the exchange rate for converting one currency into another is fixed by international agreement

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Fixed Exchange Rate Systems (1 of 3)

The Gold Standard

Advantages of the Gold Standard

- Reduced the risk in exchange rates
- Imposed strict monetary policies
- Help correct a nation’s trade imbalance

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Fixed Exchange Rate Systems

Collapse of the Gold Standard

- Aggressive printing of paper currency caused high inflation
- Decision of the United States to devalue its currency and Britain's decision not to do so:
  - Lowered the price of U.S. exports on world markets
  - Increased the price of imports from Britain (and other countries), lowering its export earnings
  - Countries devalued their currencies in retaliation
- Competitive devaluations
  - No longer an accurate indicator of a currency's true value
  - By 1939, gold standard was effectively dead

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Fixed Exchange Rate Systems (3 of 3)

- **Bretton Woods Agreement:** Agreement (1944) among nations to create a new international monetary system based on the value of the U.S. dollar
  - Incorporated fixed exchange rates
  - Incorporated a degree of built-in flexibility
  - Created the World Bank
  - Established the International Monetary Fund (IMF)
- **Collapse of the Bretton Woods Agreement**
  - U.S. trade and budget deficits
  - **Smithsonian Agreement**
  - A weak U.S. dollar
  - A large sell-off of dollars on world financial markets

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Quick Study 3

1. The gold standard is an example of what type of international monetary system?
2. What were the main advantages of the gold standard?
3. What is the name of the international monetary system that formed in 1944 following the demise of the gold standard?

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System of Floating Exchange Rates

Jamaica Agreement

- Agreement (1976) among IMF members to formalize the existing system of floating exchange rates as the new international monetary system

Managed Float System:

- Exchange rate system in which currencies float against one another, with governments intervening to stabilize their currencies at particular target exchange rates

Free Float System

- Exchange rate system in which currencies float freely against one another, without governments intervening in currency markets

Later Accords

- **The Plaza Accord:** caused traders to sell the dollar, and its value fell
- **The Louvre Accord:** affirmed that the U.S. dollar was appropriately valued

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Today’s Exchange Rate Arrangements

- **Managed Float System**
- **“Pegged” Exchange Rate Arrangement**
  - “Peg” a country’s currency to a more stable and widely used currency in international trade.
- **Currency Board**
  - Monetary regime based on an explicit commitment to exchange domestic currency for a specified foreign currency at a fixed exchange rate.

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European Monetary System (EMS)

- Established in 1979 by EU nations
  - **Exchange Rate Mechanism (ERM):** Limited the fluctuations of EU members' currencies within a specified trading range (2.25 percent of the highest- and lowest-valued members' currencies)
- The EMS was established to:
  - Stabilize exchange rates
  - Promote trade among nations
  - Keep inflation low through monetary discipline
- The EMS was quite successful in its early years
- But in late 1992, Britain and Italy were forced to leave the ERM
- Phased out when the EU adopted a single currency

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Recent Financial Crises

- Most prominent financial crises
  - Developing Nations’ Debt Crisis
  - Mexico’s Peso Crisis
  - Southeast Asia’s Currency Crisis
  - Russia’s Ruble Crisis
  - Argentina’s Peso Crisis
- Future of the international monetary system
  - Calls for a new system

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Quick Study 4

1. An exchange rate system in which currencies float against one another with governments intervening to stabilize currencies at target rates is called a what?
2. What do we call the arrangement whereby a nation lets its currency float within a margin around the value of another more stable currency?
3. A currency board is a monetary regime based on an explicit commitment to exchange domestic currency for what?

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