MODULE 15
EXCHANGE RATES AND INTERNATIONAL FINANCE

The Foreign Exchange Market

Most countries have their own currencies, but not all. Sometimes small economies use the currency of an economically larger neighbor. For example, Ecuador, El Salvador, and Panama have decided to dollarize—that is, to use the U.S. dollar as their currency. Sometimes nations share a common currency. The best example of a common currency is the Euro, a common currency used by 27 members of the European Union. The most international transactions require participants to convert from one currency to another when selling, buying, hiring, borrowing, traveling, or investing across national borders. The market in which people or firms use one currency to purchase another currency is called the **foreign exchange market**.

Demanders and Suppliers of Currency in Foreign Exchange Markets

In foreign exchange markets, demand and supply become closely interrelated, because a person or firm who demands one currency must at the same time supply another currency—and vice versa. To get a sense of this, it is useful to consider four groups of people or firms who participate in the market:
1) firms that import or export goods and services;
2) tourists visiting other countries;
3) international investors buying ownership (or part-ownership) in a foreign firm;
4) international investors making financial investments that do not involve ownership.

Firms that sell exports or buy imports find that their costs for workers, suppliers, and investors are measured in the currency of the nation where their production occurs, but their revenues from sales are measured in the currency of the different nation where their sales happened. So, a Chinese firm exporting abroad will earn some other currency—say, U.S. dollars—but will need Chinese yuan to pay the workers, suppliers, and investors who are based in China. In the foreign exchange markets, this firm will be a supplier of U.S. dollars and a demander of Chinese yuan.

International tourists need foreign currency for expenses in the country they are visiting; they will supply their home currency to receive the foreign currency. For example, an American tourist who is visiting China will supply U.S. dollars into the foreign exchange market and demand Chinese yuan.

Foreign direct investment (FDI)

Financial investments that cross international boundaries, and require exchanging currency, are often divided into two categories: Foreign direct investment and Portfolio investment.
Foreign direct investment (FDI) refers to purchasing (at least ten percent) ownership in a firm in another country or starting up a new enterprise in a foreign country.

Portfolio investment

The other kind of international financial investment, portfolio investment, involves a purely financial investment that does not entail any management responsibility. An example would be a U.S. financial investor who purchased bonds issued by the government of the United Kingdom, or deposited money in a British bank. To make such investments, the American investor would supply U.S. dollars in the foreign exchange market and demand British pounds.

Participants in the Exchange Rate Market

The foreign exchange market does not involve the ultimate suppliers and demanders of foreign exchange literally seeking each other out. If Martina decides to leave her home in Venezuela and take a trip in the United States, she does not need to find a U.S. citizen who is planning to take a vacation in Venezuela and arrange a person-to-person currency trade. Instead, the foreign exchange market works through financial institutions, and it operates on several levels.

Most people and firms who are exchanging a substantial quantity of currency go to a bank, and most banks provide foreign exchange as a service to customers. These banks (and a few other firms), known as dealers, then trade the foreign exchange. This is called the **interbank market**.

In the world economy, roughly 2,000 firms are foreign exchange dealers. The U.S. economy has less than 100 foreign exchange dealers, but the largest 12 or so dealers carry out more than half the total transactions. The foreign exchange market has no central location, but the major dealers keep a close watch on each other at all times.

Exchange Rates, Aggregate Demand, and Aggregate Supply

A central bank will be concerned about the exchange rate for three reasons:
1) Movements in the exchange rate will affect the quantity of aggregate demand in an economy;
2) frequent substantial fluctuations in the exchange rate can disrupt international trade and cause problems in a nation’s banking system;

3) the exchange rate may contribute to an unsustainable balance of trade and large inflows of international financial capital, which can set the economy up for a deep recession if international investors decide to move their money to another country.

In macroeconomics, **aggregate demand** or domestic final demand is the total demand for final goods and services in an economy at a given time. It is often called effective demand. This is the demand for the gross domestic product of a country.

In economics, **aggregate supply** or domestic final supply is the total supply of goods and services that firms in a national economy plan on selling during a specific time period. It is the total amount of goods and services that firms are willing and able to sell at a given price level in an economy.

International finance

International finance is the study of monetary interactions that transpire between two or more countries. **International finance** focuses on areas such as foreign direct investment and currency exchange rates. Increased globalization has magnified the importance of international finance.

What are the functions of finance?

In a broad sense, the finance function covers the following six major activities:

1) Financial planning;

2) Forecasting cash inflows and outflows;

3) Raising funds;

4) Allocation of funds;

5) Effective use of funds;

6) Financial control (budgetary and non-budgetary).