



# The International Monetary and Financial Environment

## Learning Objectives

In this chapter, you will learn about:

1. Currencies and exchange rates in international business
2. How exchange rates are determined
3. Development of the modern exchange rate system
4. The international monetary and financial systems
5. Key players in the monetary and financial systems

## > The Complex Monetary and Financial Relationship between China and the United States

China and the United States are large economies, providing nearly half the world's economic growth in recent years. The two countries represent the world's most important bilateral economic and trading relationship. Each has a distinct role: China is the world's leading product manufacturer, and the United States is one of the wealthiest consumer and industrial markets.

China owes much of its international trading success to the value of the renminbi, its national currency (also called the yuan). For years the renminbi has been cheap by world standards, making Chinese products inexpensive to foreign importers. The value of the renminbi is set at a fixed exchange rate to the U.S. dollar and other world currencies. The Chinese government intervenes regularly in currency markets to ensure that this fixed rate is maintained. The relatively low value of the renminbi has stimulated huge demand for Chinese-made products, a major cause of the United States' persistent trade deficit with China.

Large-scale exporting has led to massive capital inflows, making China the world's biggest holder of "foreign exchange reserves" (money that nations receive



from their international transactions, such as exporting). China has used much of these reserves to invest in U.S. government securities, helping to finance the United States' huge government budget deficits. In 2006, China purchased nearly half the issues of U.S. Treasury securities, totaling \$87 billion and making China the world's largest investor in U.S. government debt. The United States needs Chinese capital to finance its trade and budget deficits. Simultaneously, China needs the United States to buy the exports responsible for much of China's wealth.

China's fixed exchange-rate policy is one of the hottest topics in international finance. Some economists argue that the system has been good for China, stabilizing its currency and giving foreign investors the confidence to build factories in China. But other economists have argued that China's fixed rate distorts trade and investment flows. They believe China should allow its currency to float freely in response to market forces. Partly because of pressure from the United States and other countries, China revalued the renminbi slightly in 2005 to make it more expensive relative to the dollar.

When the Chinese government increased the renminbi's value, its products became more expensive to foreigners, reducing world demand for Chinese exports.



Currency revaluations of this sort can lower a country's earnings and trigger an economic recession. Because China is highly integrated into the world economy, a Chinese recession could trigger economic problems in the United States and other countries. A slowing Chinese economy could also reduce China's appetite for U.S. imports. The effect could be substantial—China is the world's biggest consumer of pork, cotton, coal, aluminum, steel, washing machines, cell phones, and a host of other products.

China and the United States are inextricably linked in a complex relationship, critical to

the economic health of both countries. How this relationship evolves over time will determine, to a great extent, the future prosperity of the world economy. ◀

Sources: Areddy, James. (2007). "China's Rate Boost Shows Economy's Vigor," *Wall Street Journal*, March 19, p. A2; Batson, Andrew. (2007). "China Says It Won't Rattle Markets," *Wall Street Journal*, March 17–18, p. A10; *Economist*, (2004). "A Survey of the World Economy: The Dragon and the Eagle," October 2, special section; Field, Alan. (2005). "China Revalues Yuan," *Journal of Commerce*, July 21, p. 1; Morici, Peter. (2005). "Why China Should Revalue the Yuan," *Journal of Commerce*, July 4, p. 1; Norris, Floyd. (2007). "Washington Dares to Challenge the Lender It Depends Upon," *New York Times*, April 14, p. C3; *Wall Street Journal* (2005). "China's Currency Bow," July 22, p. A12.

**A**s the opening vignette demonstrates, international business transactions take place within the global monetary and financial systems. Understanding these systems is fundamental to company success. When people think of international trade, they invariably think of trade in products and services. However, the markets for foreign exchange and capital are much larger. Firms regularly trade the U.S. dollar, European euro, Japanese yen, and other leading currencies to meet their international business obligations. This trade requires that nations exchange currencies with each other. The exchange rate links different national currencies so that international price and cost comparisons can be made. In this chapter, we explore the monetary and financial structure that makes trade and investment possible. We explain the nature, organization, and functions of the foreign exchange market and the monetary and financial dimensions of how companies facilitate international transactions.



## Currencies and Exchange Rates in International Business

Cross-border transactions occur through an exchange of currencies between buyers and sellers. A currency is a form of money and a unit of exchange. The tendency of each country to prefer to use its own unique currency complicates international business transactions. There are some 175 currencies in use around the world. When buying a product or a service from a Mexican supplier, for example, you must convert your own currency into Mexican pesos in order to pay the supplier. However, the currency regime is simplifying in some locations. Numerous countries in Europe use the euro, and a few countries, such as Panama, have adopted the U.S. dollar as their currency.

Exhibit 10.1 provides the exchange rates for the U.S. dollar and a sample of currencies on a recent day. The value of national currencies is in constant flux. The **exchange rate**—the price of one currency expressed in terms of another—varies over time. This fluctuation means you have to keep three things in mind. First is the issue of whether you and your Mexican supplier agreed on an exchange rate in advance, or if the exchange rate is to be decided on the date of the actual payment. Second, you should keep in mind whether the purchase agreement quoted the price in your currency or in the supplier's currency. Third, because several months can pass from the time you place an order to the time the order arrives, fluctua-

**Exchange rate** The price of one currency expressed in terms of another. It is the number of units of one currency that can be exchanged for another.

**Exhibit 10.1**

U.S. Dollar Exchange Rates for a  
Sample of Currencies as of  
October 2, 2007

SOURCE: © 2007 xrates.com, all rights reserved.

	<i>Currency per one U.S. dollar</i>	<i>U.S. dollars per unit of currency</i>
Australian dollar	\$1.130	\$0.885
Brazilian real	1.822	0.549
British pound	0.490	2.042
Canadian dollar	1.000	1.000
Chinese renminbi (yuan)	7.509	0.133
Euro	0.706	1.416
Indian rupee	39.650	0.025
Japanese yen	115.830	0.009
Mexican peso	10.910	0.092
New Zealand dollar	1.314	0.761
Norwegian kroner	5.423	0.184
Singapore dollar	1.484	0.674
Saudi Arabian riyal	3.750	0.267
South African rand	6.909	0.145
Turkish lira	1.204	0.830

tions in the exchange rate during that time could cost you money or earn you money, because what you pay or receive is higher or lower than at the time of the transaction.

These and similar complications in cross-border transactions create **currency risk**, the risk that arises from changes in the price of one currency relative to another. It is one of the four types of risks encountered in international business that we illustrated in Exhibit 1.6 on page 11. If you purchase from a supplier whose currency is appreciating against yours, you face a currency risk, since you may need to hand over a larger amount of your currency to pay for your purchase. If you expect a payment from a customer whose currency is depreciating against your own, currency risk also arises, because you may receive a smaller payment amount in your currency, if the sale price was expressed in the currency of the customer. Of course, if the foreign currency fluctuates in your favor, you may gain a windfall. Nevertheless, exporters or importers are not usually in the business of making money from currency speculation; they are typically concerned about *losses* that arise from currency fluctuations.

Exporters and licensors face risk also because foreign buyers either pay in a foreign currency, or they must convert their currency into that of the vendor. Foreign direct investors face currency risk because they both receive payments and incur obligations in foreign currencies.

### Convertible and Nonconvertible Currencies

A *convertible currency* can be readily exchanged for other currencies. The most convertible currencies are called *hard currencies*. They are strong, stable currencies that are universally accepted, such as the U.S. dollar, Japanese yen, Canadian dollar, British pound, and the European euro. These are the currencies used most for international business transactions. Nations prefer to hold hard currencies as reserves because of their strength and stability in comparison to other currencies.

A currency is *nonconvertible* when it is used for domestic transactions and is not acceptable for international transactions. In some cases, the government may not allow it to be converted into a foreign currency. Currency convertibility is so strict in some developing economies that firms sometimes avoid using currencies altogether and receive payments in the form of products rather than cash; in other

**Currency risk** Risk that arises from changes in the price of one currency relative to another.



words, they engage in a form of barter. Governments impose restrictions on the convertibility of their currency in order to preserve their supply of hard currencies, such as the U.S. dollar or the euro, or to avoid the problem of *capital flight*—the possibility that residents or foreigners will sell their holdings in the nation's currency or convert it into a foreign currency. Capital flight diminishes a country's ability to service debt and pay for imports.

As an example, foreign investors sometimes drastically reduce their investments in a particular country and its currency. This occurs because people believe that their holdings are more likely to maintain their value when converted into a different currency (usually a hard currency, such as the U.S. dollar or euro) or invested elsewhere. For example, between 1979 and 1983, some \$90 billion reportedly left Mexico when foreign lenders lost confidence in the Mexican economy and investors took their money out of the country. In 2007, Ecuador's president, Rafael Correa, dismissed 57 opposition members of Congress and embarked on a plan to write a new constitution and transform Ecuador's legal framework. Some Ecuadorians fear that Correa is attempting to establish a dictatorship. In 2006, Correa expropriated Occidental Petroleum, previously Ecuador's largest foreign investor. Correa's unpredictable actions have panicked foreign investors and Ecuador's wealthier citizens, who have withdrawn millions of dollars from the country's economy.<sup>1</sup>

## Foreign Exchange Markets

A critical function of money is to facilitate payment for the products and services that the firm sells. When doing business in the home country, getting paid is straightforward—the U.S. dollar is acceptable throughout the United States, the euro is widely used in Europe, and the Japanese need only yen when buying and selling with each other. But suppose a Canadian needs to pay a Japanese, or a Japanese needs to pay an Italian, or an Italian needs to pay a Canadian. What then? The Canadian wants to be paid in Canadian dollars, the Japanese wants to be paid in yen, and the Italian wants to be paid in euros. Each of these currencies—the Canadian dollar, yen, and euro—is known as *foreign exchange*. **Foreign exchange** represents all forms of money that are traded internationally, including foreign currencies, bank deposits, checks, and electronic transfers. Foreign exchange resolves the problem of making international payments and facilitates the international investment and borrowing among firms, banks, and governments.

Currencies such as the U.S. dollar, yen, and euro are traded on the **foreign exchange market**, the global marketplace for buying and selling national currencies. The market has no fixed location. Rather, trading occurs through continuous buying and selling among banks, currency traders, governments, and other exchange agents located worldwide. International business would be impossible without foreign exchange and the foreign exchange market.

## Exchange Rates Are in Constant Flux

Sometimes there are dramatic fluctuations in the exchange rate between the U.S. dollar and the euro and between numerous other currencies, as illustrated in Exhibit 10.2. In 1985, the Japanese yen was trading at 240 yen to the U.S. dollar. By 1988, the yen had fluctuated to just 125 yen to the dollar, an appreciation of almost 50 percent. Implications for international business with Japan were huge. In the span of just three years, Japanese firms witnessed a significant downturn in their exports, as Japanese products became substantially more expensive in dollar terms. Meanwhile, as the dollar buying power of the Japanese increased, U.S. firms experienced a surge in their exports to Japan.<sup>2</sup> Exhibit 10.2 also shows that the French franc is one of those Eurozone-country currencies that was taken out of circulation and replaced by the euro.

**Foreign exchange** All forms of money that are traded internationally, including foreign currencies, bank deposits, checks, and electronic transfers.

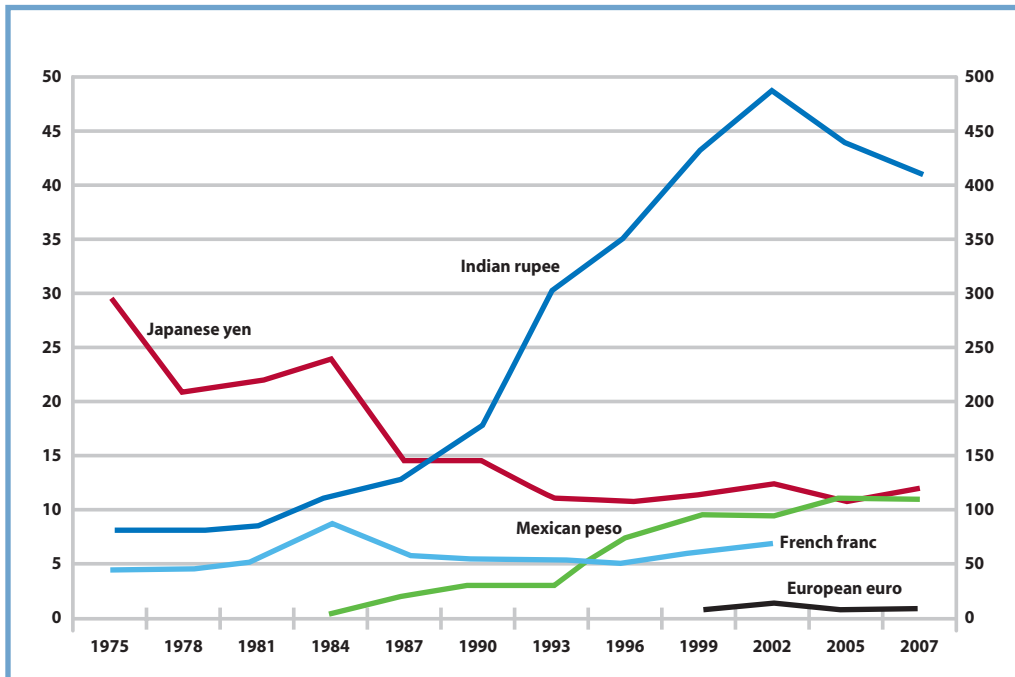
**Foreign exchange market** The global marketplace for buying and selling national currencies.

## Exhibit 10.2

Selected Exchange Rates to the U.S. Dollar over Time

Notes: Right-hand scale is for Japanese yen; Left-hand scale is for all other currencies. The euro became the common currency of various countries in the European Union in 1999, replacing the French franc and other European currencies. The Mexican Peso was revalued in 1983.

SOURCE: IMF and World Bank data.



Lincoln Electric Co. in Cleveland, Ohio, has been able to export much more of its arc-welding products to Europe because of the recent weakening of the U.S. dollar relative to the euro.<sup>3</sup> Conversely, for U.S. consumers, the euro is relatively more expensive and may discourage them from buying European products. This has affected firms such as Volkswagen, whose U.S. sales fell off as a result of the higher cost to U.S. buyers.<sup>4</sup> This type of currency risk is a natural outcome of multicountry operations.

Fluctuating exchange rates affect both firms and customers. Suppose that today, the euro/dollar exchange rate is €1 = \$1; that is, for a European to buy one United States dollar, she or he must pay one euro. Next, suppose that during the coming year the exchange rate goes to €1.50 = \$1. Compared to before, the dollar is much more expensive to European firms and consumers—it costs 50 percent more to acquire a dollar. Let's examine the effect of this change on Europeans.<sup>5</sup>

### Effect on European Firms:

- European firms must pay more for inputs from the United States—such as raw materials, components, and support services—that they use to produce finished products and services.
- Higher input costs reduce profitability and may necessitate firms raising prices to final customers; these higher prices lower customer demand for goods and services.
- Because the euro has become less expensive for U.S. consumers, firms can increase their exports to the United States. Firms can even raise their export prices and remain competitive in the U.S. market.
- Increased exports to the United States generate higher revenues and higher profits.

### Effect on European Consumers:

- Because U.S. products and services now cost more, European consumers demand fewer of them.
- The cost of living rises for those Europeans who consume many dollar-denominated imports.
- Fewer European tourists can afford to visit the United States. Fewer European students study at U.S. universities.

Now, suppose that the euro/dollar exchange rate goes to  $\text{€}0.50 = \$1$ . What are the effects on European firms and consumers? The effects are essentially the opposite of those summarized above: European firms pay less for inputs from the United States, which means the firms can drop their prices on goods and services. Because U.S. products and services now cost less, consumers demand more of them. As you can see, the effects of a fluctuating exchange rate have an affect on both sides of international transactions. Management must monitor exchange rates constantly and devise strategies to optimize firm performance in light of strong and weak currencies. We discuss these strategies in Chapter 19.

In 1999, 11 member states in the European Union switched to a single currency—the euro—eliminating the problem of exchange rate fluctuations among the participating nations (physical coins and banknotes came into circulation later, in 2002). As of January 2007, 13 member states were participating in the Eurozone. Fluctuations in exchange rates motivate countries to coordinate their monetary policies at regular meetings of the Bank for International Settlements and the G8, the group of eight major industrial countries. Governments attempt to manage exchange rates by buying and selling hard currencies and by keeping inflation in check. However, the foreign exchange market has become so huge and its movements so fluid that even major governments have difficulty controlling exchange rate movements.



## How Exchange Rates Are Determined

In a free market, the “price” of any currency—that is, its rate of exchange—is determined by supply and demand. The levels of supply and demand for the currency, as with most commodities, will vary inversely with its price. Thus, all else being equal:

- The greater the supply of a currency, the lower its price.
- The lower the supply of a currency, the higher its price.
- The greater the demand for a currency, the higher its price.
- The lower the demand for a currency, the lower its price.

Let’s assume a U.S. consumer would like to buy a German car, such as a BMW, with a nominal price of 25,000 euros. Assume further that the euro/dollar exchange rate is one euro equals \$1.25. Now suppose the consumer delays six months, during which the exchange rate shifts, with the new rate becoming one euro equals \$1.50. That is, due to increased demand for euros and/or decreased supply of euros, the euro has become more expensive to U.S. customers. In this case, the consumer will be less inclined to buy the BMW because, ultimately, she or he must buy expensive euros to obtain the car. By contrast, if, during the six-month period, the euro becomes cheaper to the consumer (with, say, an exchange rate of one euro equals one dollar), she or he will be more inclined to buy the BMW. As this example implies, the greater the demand for a country’s products and services, the greater the demand for its currency.

Broadly speaking, there are four main factors that influence the supply and demand for a currency: economic growth, interest rates and inflation, market psychology, and government action. Let’s review each of these factors next.

### Economic Growth

*Economic growth* is the increase in value of the goods and services produced by an economy. It is usually measured as the annual increase in real GDP, in which the inflation rate is subtracted from the economic growth rate in order to obtain a more accurate measure. Economic growth results from continual economic activi-



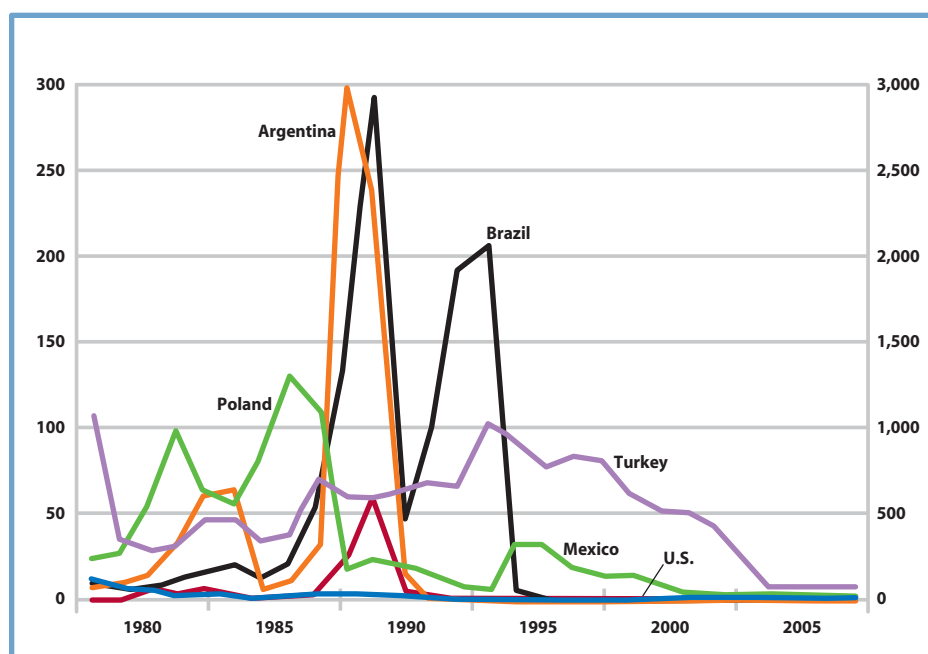
ties, including innovation and entrepreneurship. It implies a continued increase in business activities and a corresponding increase in consumer need for money to facilitate more economic transactions. To accommodate economic growth, the central bank increases the nation's money supply. The **central bank** is the monetary authority in each country that regulates the money supply, issues currency, and manages the exchange rate of the nation's currency relative to other currencies. Economic growth is associated with an increase in the supply and demand of the nation's money supply, and by extension, the nation's currency. Thus, economic growth has a strong influence on the supply and demand for national currencies. For example, several East Asian countries have experienced rapid economic growth in recent years. This has stimulated a steadily increasing demand for the currencies of these countries by firms and individuals, both domestic and foreign.

## Interest Rates and Inflation

*Inflation* is an increase in the price of goods and services, so that money buys less than in preceding years. Exhibit 10.3 shows that inflation rates have reached high levels in some countries over time. Countries such as Argentina, Brazil, and Zimbabwe have had prolonged periods of *hyperinflation*—persistent annual double-digit and indeed triple-digit rates of consumer price increases. A practical effect of this hyperinflation is the need, say, for a restaurant owner to change the menu every few days in order to list the most recent prices. In a high-inflation environment, the purchasing power of the currency is constantly falling. Interest rates and inflation are closely related. In countries with high inflation, interest rates tend to be high. This occurs because investors expect to be compensated for the inflation-induced decline in the value of their money. So, if inflation is running at 10 percent, for example, banks have to pay *more* than 10 percent interest to attract customers to open savings accounts.

Fundamentally, inflation occurs when: (1) demand grows more rapidly than supply, or (2) the central bank increases the nation's money supply faster than output. When a disproportionately large amount of money is introduced into an economy, the result is too much money chasing a relatively fixed supply of goods

**Central bank** The monetary authority in each nation that regulates the money supply and credit, issues currency, and manages the exchange rate of the nation's currency.



## Exhibit 10.3

Inflation in Selected Countries, 1980–2005

Note: Chart shows annual percentage rate of inflation. Right-hand scale is for Argentina, Brazil, and Poland; left-hand scale is for all the other countries.

SOURCE: International Monetary Fund ([www.imf.org](http://www.imf.org))



In response to Argentina's financial crisis in 2001, anxious customers in Buenos Aires lined up to withdraw their money at a branch of Bank Boston. Argentina experienced massive capital flight when the government announced it would default on its international loans, which imperiled Argentine banks.

and services, which causes prices to go up. For instance, triggered by sizeable increases in the national money supply, inflation was running at over 400 percent per year in Brazil in the mid-1990s. Imagine the difficulty both buyers and sellers would have adjusting to constant decline of the currency's value, and ever-rising prices!

Inflation affects the value of the nation's currency in a major way. If inflation results from an excessive increase in the money supply, all else being equal, the price of that money (as expressed in terms of foreign currencies) will fall. In other words, an oversupply of money causes its value to fall. In this way, a rise in inflation causes the value of the national currency to fall.

The link between interest rates and inflation, and between inflation and the value of currency, implies that there is a relationship between real

interest rates and the value of currency. For example, when interest rates in Japan are high, foreigners seek profits by buying Japan's interest-bearing investment opportunities, such as bonds and deposit certificates. Investment from abroad will have the effect of increasing demand for the Japanese yen.

## Market Psychology

Exchange rates are often affected by *market psychology*, the unpredictable behavior of investors. Investors may engage in *herding behavior* and/or *momentum trading*. Herding refers to the tendency of investors to mimic each others' actions. It results partly because a disagreement of opinion creates anxiety and a desire to seek consensus and, thereby, follow the behavior of others. Momentum trading is a type of behavior in which investors buy stocks whose prices have been rising and sell stocks whose prices have been falling. It is usually carried out using computers that are set to do massive buying or selling when asset prices reach certain levels. Herding and momentum trading tend to occur in the wake of financial crises. A case in point is Argentina, which experienced a massive flight of capital investment when the government announced it would default on its international bank loans in 2001. Foreign investors panicked and deserted Argentina in droves.<sup>6</sup>

## Government Action

The pricing of currencies affects company performance. When a nation's currency is expensive to foreigners, the nation's exports are likely to fall.<sup>7</sup> When a nation's currency is cheap to foreigners, the nation's exports increase. When the value of a nation's currency depreciates over a prolonged period, consumer and investor confidence can be undermined. A steep currency depreciation weakens the nation's ability to pay foreign lenders, possibly leading to economic and political crisis.

To minimize these effects, governments often intervene to influence the value of their own currencies. As seen in the opening vignette, the Chinese government regularly intervenes in the foreign exchange market to maintain the value of the renminbi at a desirable level. This is done to keep the renminbi undervalued, helping to ensure that Chinese exports remain strong.

An undervalued national currency can result in a **trade surplus**, which results when a nation's exports exceed its imports for a specific period of time, causing a net inflow of foreign exchange. By contrast, a **trade deficit** results when a nation's imports exceed its exports for a specific period of time, causing a net outflow of foreign exchange. The *balance of trade* is the difference between

**Trade surplus** The amount by which a nation's exports exceed its imports for a specific period of time.

**Trade deficit** The amount by which a nation's imports exceed its exports for a specific period of time.

the monetary value of a nation's exports and its imports over the course of a year. For example, if Germany exports cars to Kenya, money flows out of Kenya and into Germany, because the car importer in Kenya pays the exporter in Germany. This results in a surplus item in Germany's balance of trade and a deficit item in Kenya's balance of trade. If the total value of Kenya's imports from Germany became greater than the total value of Kenya's exports to Germany, then Kenya would have a trade deficit with Germany. Factors that can affect the level of the balance of trade include the prices of goods manufactured at home, exchange rates, trade barriers, and the method used by the government to measure the trade balance.

Many economists believe a persistent trade deficit is harmful to the national economy. When a trade deficit becomes severe or persists over a long period of time, the nation's central bank may devalue its currency. A **devaluation** is a government action to reduce the official value of its currency, relative to other currencies. It is usually accomplished by buying and selling currencies in the foreign exchange market. Devaluation aims to deter the nation's residents from importing from other countries, potentially reducing the trade deficit.<sup>8</sup> The *Global Trend* feature on the next page explains the large trade deficits that the U.S. economy has experienced in recent decades.

At a broader level, governments must manage their **balance of payments**, the annual accounting of *all* economic transactions of a nation with all other nations. The balance of payments is the nation's balance sheet of trade, investment, and transfer payments with the rest of the world. It represents the difference between the *total* amount of money coming into and going out of a country. Consider the case of a Japanese MNE that builds a factory in China. In the process of investing in China to build the factory, money flows out of Japan and into China, generating a deficit item for Japan and a surplus item for China, in their respective balance of payments. The balance of payments is affected by other transactions as well, as when citizens donate money to a foreign charity, when a government provides foreign aid, or when tourists travel internationally, spending their money abroad.

**Devaluation** Government action to reduce the official value of its currency, relative to other currencies.

**Balance of payments** The annual accounting of all economic transactions of a nation with all other nations.

## Development of the Modern Exchange Rate System

Despite several decades of rising international trade, the years before World War II (1939–1945) were characterized by turmoil in the world economy. The Great Depression (1929–1939) and the war coincided with a collapse of the international trading system and of relations among nations. Following the war, some countries came together to energize international commerce and to devise a framework for stability in the international monetary and financial systems. In 1944, the governments of 44 countries negotiated and signed the Bretton Woods agreement.

The Bretton Woods accord pegged the value of the U.S. dollar to an established value of gold, at a rate of \$35 per ounce. The U.S. government agreed to buy and sell unlimited amounts of gold in order to maintain this fixed rate. Each of Bretton Woods' other signatory countries agreed to establish a par value of its currency in terms of the U.S. dollar and to maintain this pegged value through central bank intervention. In this way, the Bretton Woods system kept exchange rates of major currencies fixed at a prescribed level, relative to the U.S. dollar and, therefore, to each other.

The demise of the Bretton Woods agreement began in the late 1960s when the United States government employed deficit spending to finance both the Vietnam War and expensive government programs. Rising government spending stimulated the economy and U.S. citizens began spending more on imported goods, aggravating the U.S. balance of payments. The United States acquired trade deficits with



## Is the U.S. Trade Deficit Good or Bad?

The United States has posted annual trade deficits since 1971. The deficit in merchandise goods (excluding services) has grown substantially in recent years, reaching a record level of \$856 billion in 2006. This represented 6.5 percent of the U.S. gross domestic product. It also meant that the country was borrowing more than \$2 billion daily in order to finance its trade gap. In recent years, China has contributed to nearly a quarter of this trade deficit. But the United States also has a trade deficit with its other major trading partners, including Canada, Mexico, and the oil-producing countries in the Middle East.

Persistent trade deficits can be harmful because, like a household whose spending exceeds its income, more money flows out of a country than coming in. Trade deficits can produce higher interest rates, inflation, and general economic instability. To finance a trade deficit, the United States has to sell assets or borrow money from foreigners. For instance, the United States borrows money from China, Japan, and other governments when they invest in U.S. treasury bonds and treasury bills. A persistent deficit means the United States is accumulating a lot of foreign debt.

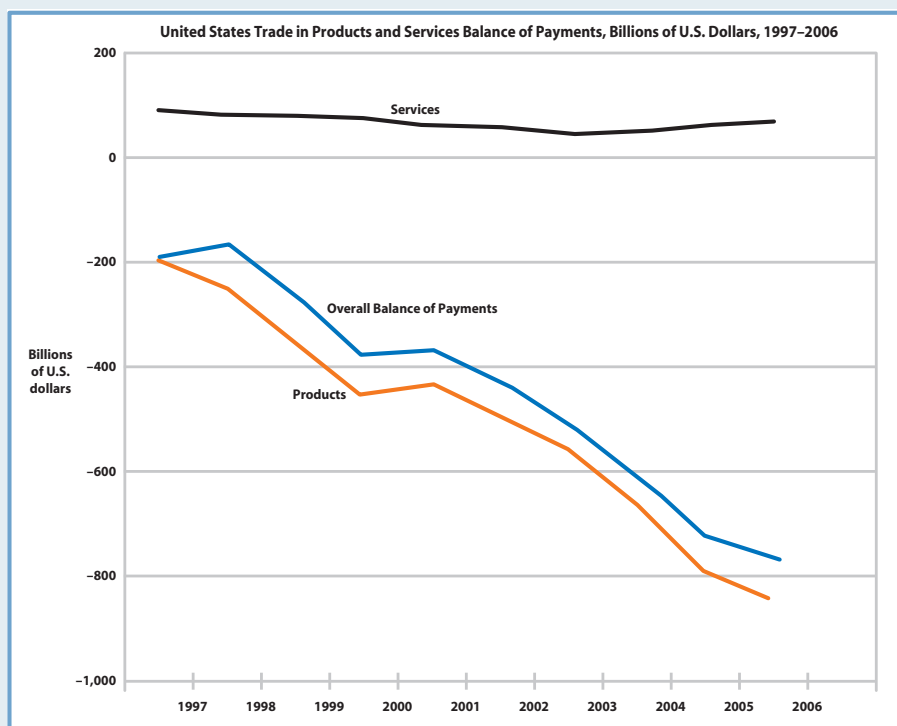
Each country's balance of trade is closely tied to the exchange rate of its currency. If a country has a trade surplus, there is relatively more demand for its currency and the currency can strengthen, or appreciate, over time. Conversely, if the nation has a chronic deficit position, its currency will weaken, or depreciate, over time. Big U.S.

trade deficits partly explain the weakening of the U.S. dollar in foreign exchange markets.

Trade deficits are not inherently good or bad. They must be judged based on the circumstances in which they arose. For one, the deficit is not harmful if it results from imports of input goods used to manufacture higher-value finished products, many of which are exported. Second, trade deficits are generally measured in terms of *merchandise trade*. But, as the exhibit shows, the United States does have a trade surplus in international services, which offsets some of the merchandise trade deficit. Third, the United States attracts much inward foreign direct investment. Although inward

FDI does not affect the trade deficit in the government's official accounting, it does, over time, offset a portion of the deficit.

Many factors contribute to the persistent deficit, including the tendency of many countries to use the U.S. dollar as their reserve currency, which encourages dollars to flow out of the United States. In addition, the United States is dependent on many imports, including oil, autos, and computer equipment. The trend has intensified as the United States has become a services-based economy—more than two-thirds of the U.S. GDP is now derived from the services sector—with a commensurate decrease in the size of the U.S. manufacturing sector.



Japan, Germany, and other European countries. Over time, demand for U.S. dollars so exceeded their supply that the U.S. government could no longer maintain an adequate stock of gold. This situation put pressure on governments in Europe, Japan, and the United States to revalue their currencies, a solution that none were willing to implement. As a result, President Nixon suspended the link between the U.S. dollar and gold in 1971, and withdrew the U.S. promise to exchange gold for U.S. dollars. This action essentially brought an end to the Bretton Woods system. U.S. government budget and trade deficits persist to the present day.

Bretton Woods left a legacy of principles and institutions that remain in use today. First, Bretton Woods instituted the concept of international monetary cooperation, especially among the central banks of leading nations. Second, it established the notion of fixing exchange rates within an international regime so as to minimize currency risk. Third, it created the **International Monetary Fund (IMF)** and the **World Bank**. The IMF is an international agency that attempts to stabilize currencies by monitoring the foreign exchange systems of member countries and by lending money to developing economies. The World Bank is an international agency that provides loans and technical assistance to low- and middle-income countries, with the goal of reducing poverty. Finally, Bretton Woods established the importance of currency convertibility, in which all countries adhere to a system of unfettered multilateral trade and conversion of currencies. According to this system, member countries agree to refrain from imposing restrictions on currency trading and agree not to engage in discriminatory currency arrangements. This principle is an important aspect of the trend toward global free trade that the world is experiencing today.

### **International Monetary Fund**

**(IMF)** An international agency that aims to stabilize currencies by monitoring the foreign exchange systems of member countries, and lending money to developing economies.

**World Bank** An international agency that provides loans and technical assistance to low and middle-income countries with the goal of reducing poverty.

## **The Exchange Rate System Today**

With the collapse of Bretton Woods, almost all major currencies began to be traded freely in world markets, and their value floated according to the forces of supply and demand. The official price of gold was formally abolished and governments became free to choose the type of exchange rate system that best suited their individual needs. Fixed exchange rate systems were given equal status with floating exchange rate systems, and countries were no longer compelled to maintain specific pegged values for their currency. Instead, they were urged to pursue domestic economic policies that would support the stability of their currency relative to others. The exchange rate system today comprises two main types of foreign exchange management: the floating system and the fixed system.

*The Floating Exchange Rate System.* Most advanced economies use the floating exchange rate system. Under this system, governments refrain from systematic intervention and each nation's currency floats independently, according to market forces. Major world currencies—including the Canadian dollar, the British pound, the euro, the U.S. dollar, and the Japanese yen—float independently on world exchange markets. Their exchange rates are determined daily by the forces of supply and demand. The system gives governments the latitude to modify monetary policy to fit the circumstances that they face at any time. If a country is running a trade deficit, the floating rate system allows for this to be corrected more naturally than if the country uses a fixed exchange rate regime.

*The Fixed Exchange Rate System.* Under the fixed exchange rate system, sometimes called a *pegged* exchange rate system, the value of a currency is set relative to the value of another (or the value of a basket of currencies) at a specified rate. It is the opposite of the floating exchange rate system. As the reference value rises and falls, so does the currency pegged to it. In the past, some currencies were also fixed to some set value of gold. The fixed exchange rate system was the system used in the Bretton Woods agreement. Many developing economies and some emerging

markets use this system today. For example, as noted in the opening vignette, China pegs its currency to the value of a basket of currencies. Belize pegs the value of its currency to the U.S. dollar. To maintain the peg, the governments of these countries intervene in currency markets to buy and sell dollars and other currencies, in order to maintain the exchange rate at a fixed, preset level.

A fixed regime promotes greater stability and predictability of exchange rate movements and provides greater certainty and stability within a nation's economy. The central bank must stand ready to fill any gaps between supply and demand for its currency.

Many economists believe floating exchange rates are preferable to fixed exchange rates because floating rates more naturally respond to, and represent, the supply and demand for currencies in the foreign exchange market. In some situations, however, fixed exchange rates may be preferable for their greater stability. For example, the Asian financial crisis was contained in part because of China's adherence to a fixed exchange regime. A fixed regime provided much stability to world currencies under the Bretton Woods system in the years following World War II.

At times, countries adhere to neither a purely fixed exchange rate nor a floating exchange rate system. Rather, they try to hold the value of their currency within some range against the U.S. dollar or other important reference currency, in a system often referred to as *dirty float*. That is, the value of the currency is determined by market forces, but the central bank intervenes occasionally in the foreign exchange market to maintain the value of its currency within acceptable limits relative to a major reference currency. Many Western countries resort to this type of intervention from time to time.



## The International Monetary and Financial Systems

We've seen how currencies facilitate international transactions and how exchange rates affect the amount of international trade. Let's now examine the two systems that determine exchange rates: the international monetary system and the global financial system.

The **international monetary system** refers to the institutional framework, rules, and procedures by which national currencies are exchanged for one another. The **global financial system** refers to the collective financial institutions that facilitate and regulate the flows of investment and capital funds worldwide. Key players in the global financial system include finance ministries, national stock exchanges, commercial banks, and central banks, as well as the Bank for International Settlements, the World Bank, and the International Monetary Fund. Thus, the global financial system incorporates the national and international banking systems, the international bond market, the collective of national stock markets, and the market of bank deposits denominated in foreign currencies.

### International Monetary System

The international monetary system includes institutional arrangements that countries use to govern exchange rates. The international monetary system affects the financial activities of governments worldwide and is the basis for international financial markets. For example, if a U.S. investor wants to buy stocks on the London Stock Exchange, the exchange rate of the British pound to the U.S. dollar will affect the investor's earnings.

Of greatest importance to international business, however, is the role that the system plays in facilitating cross-border trade and investment. Firms seek to get paid for the products and services that they sell abroad. The resulting monetary flows take the form of various currencies traded between nations.

#### International monetary

**system** Institutional framework, rules, and procedures by which national currencies are exchanged for one other.

**Global financial system** The collective of financial institutions that facilitate and regulate investment and capital flows worldwide, such as central banks, commercial banks, and national stock exchanges.



## Global Financial System

The global financial system is built on the activities of firms, banks, and financial institutions, all engaged in ongoing international financial activity. The system has many linkages with national financial markets. Since the 1960s, the global financial system has grown substantially in volume and structure, becoming increasingly more efficient, competitive, and stable.

Today, the global financial system can accommodate massive cross-national flows of money and the massive foreign exchange markets that they have engendered. Initially triggered by the rapid growth in world trade and investment, the globalization of finance accelerated in the 1990s with the opening of the former Soviet Union and China to international business. More recently, massive cross-national flows of capital—mostly in the form of pension funds, mutual funds, and life insurance investments—are driving equity markets in many countries. Firms can increasingly access a range of capital markets and financial instruments all over the world.<sup>9</sup>

While flows of FDI-related funds have been noteworthy since the 1960s, money flowing abroad as portfolio investments is a relatively new trend. The volume of these flows has become enormous. In 2005, for example, about 15 percent of U.S. equity funds were invested in foreign stocks.<sup>10</sup> Facilitation of financial flows benefits developing economies by increasing their foreign exchange reserves, reducing their cost of capital, and stimulating local development of financial markets.

The growing integration of the financial and monetary activity worldwide is due to several drivers, including:

- The evolution of monetary and financial regulations worldwide.
- The development of new technologies and payment systems and the use of the Internet in global financial activities.
- Increased global and regional interdependence of financial markets.
- The growing role of single-currency systems, such as the euro.

The globalization of financial flows has yielded many benefits. Yet by increasing the volume and speed of international capital flows, it has also led to possibilities of financial risk. Capital flows are much more volatile than FDI-type investments. It is much easier for investors to withdraw and reallocate liquid capital funds than FDI funds, which are directly tied to factories and other permanent operations that firms establish abroad.<sup>11</sup> Economic difficulties that one country experiences can quickly spread to other countries, like a contagion. **Contagion** refers to the tendency of a financial or monetary crisis in one country to spread rapidly to others due to the ongoing worldwide financial integration. Financial instability is worsened when governments fail to adequately regulate and monitor their banking and financial sectors.<sup>12</sup>

A good example of a contagion is the financial crisis in East Asia in the late 1990s, which occurred in the wake of rapid growth that the region experienced from international trade, FDI, and access to the global financial market. The crisis



The international monetary system provides the framework within which national currencies, including the U.S. dollar, British pound, and the euro, are exchanged for another.

**Contagion** The tendency of a financial or monetary crisis in one country to spread rapidly to others due to ongoing financial integration worldwide.

was caused in part by careless banking practices that resulted in vast sums being loaned out to firms and individuals who often lacked the ability to repay the loans. Foreign investors had become overly enthusiastic about the region's prospects, and poured capital into East Asia, often with little regard for high levels of risk and poor underlying fundamentals in local economies. Investors rapidly withdrew their investments once they grasped the extent of risk and instability in the region's economies and banking systems. This capital flight made an already dire economic crisis worse.<sup>13</sup>

Let's discuss various organizations that attempt to mitigate capital flight and manage other challenges in the global monetary and financial systems.



## Key Players in the Monetary and Financial Systems

A variety of national, international, private, and government players make up the international monetary system and the global financial system. Exhibit 10.4 highlights the major players and illustrates the relationships among them. These players operate at the levels of the firm, the nation, and the world.

### The Firm

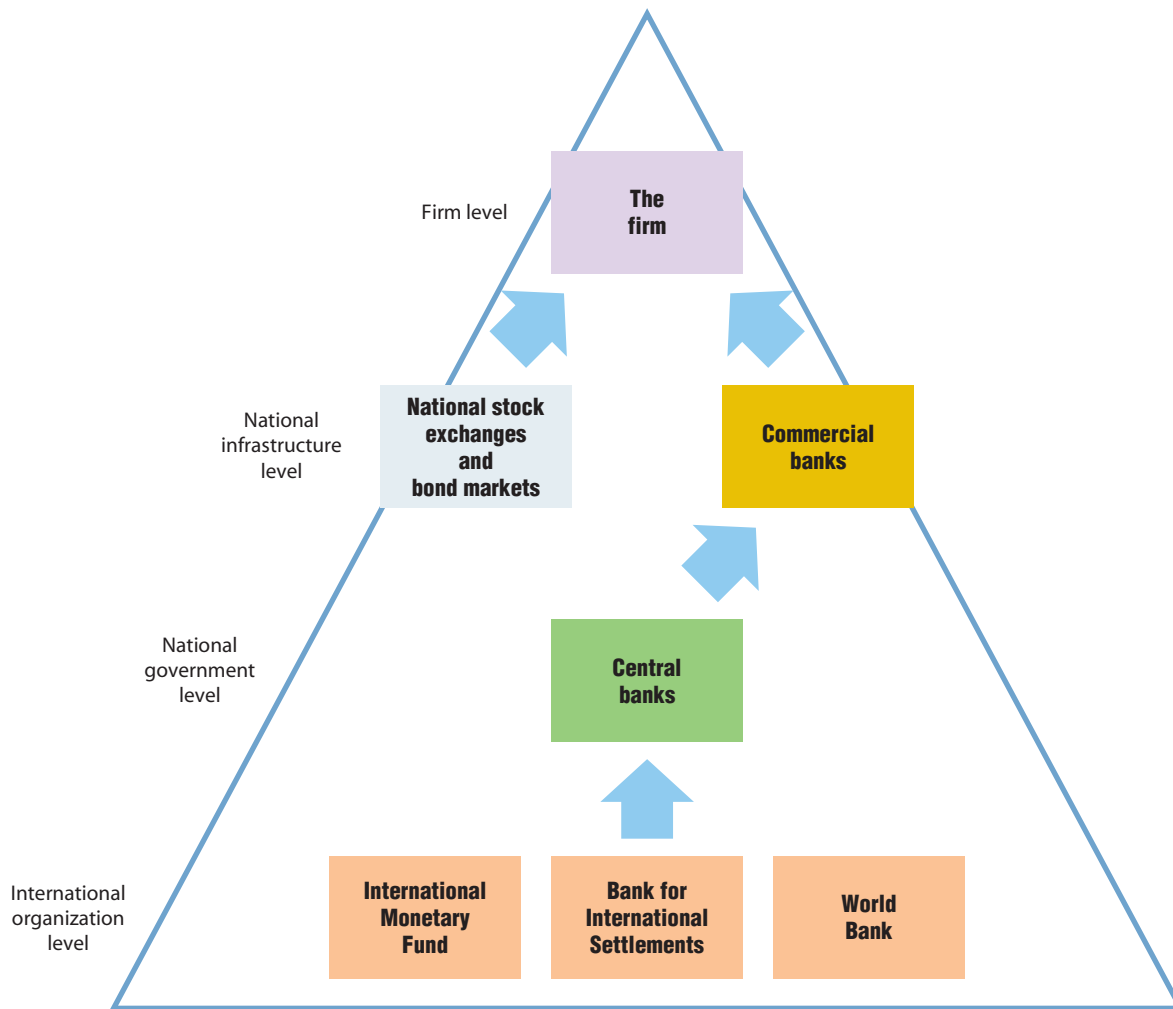
Cross-border buying and selling activities of business enterprises require them to acquire large quantities of foreign exchange. Customers make payments to firms in the course of international business transactions. The firm typically receives earnings from international operations in foreign currencies and must convert them into the currency of the home country. Firms also engage in investment, franchising, or licensing activities abroad that generate revenues that they must exchange into the home currency. For example, Jim Moran Enterprises in Florida is the largest importer of Toyota cars in the United States, and must ultimately pay for its imports in Japanese yen. Moran imports thousands of Toyotas into U.S. ports every year, and deals with the foreign exchange market to convert U.S. dollars to yen.

Some larger, more experienced MNEs with spare cash may acquire foreign currencies for speculative purposes. That is, they may hold foreign currency with a view to profiting from fluctuations in exchange rates. Other firms may acquire foreign currency in order to be able to invest in foreign stock markets and other foreign investment vehicles to obtain short-term gains.

Other private-sector players involved in the international monetary and financial system include life insurance companies, savings and loan associations, and stockbrokers that manage pensions and mutual funds. Some large MNEs have in-house finance departments that manage the foreign exchange and financial transactions of the firm. Nontraditional financial institutions like Western Union play a key role in international transfers of funds. In 2003, foreign residents in the United States used Western Union to wire billions of dollars to family members in India (\$10 billion), Mexico (\$9.9 billion), and Morocco (\$3.3 billion). These funds were converted into local currencies.<sup>14</sup>

### National Stock Exchanges and Bond Markets

A *stock exchange* is a facility for the trading of securities and other financial instruments. The traded securities include the shares issued by companies, trust funds, and pension funds, as well as corporate and government bonds. Stock exchanges are a major source of funds for firms to engage in international business. Information technology has revolutionized the functioning of stock markets, providing



**Exhibit 10.4** Key Participants and Relationships in the Global Monetary and Financial Systems

huge advances in speed and cost of transactions. Today, many exchanges are electronic networks not necessarily tied to a fixed location.

Each country sets its own rules for issuing and redeeming stock. Trade on a stock exchange is by members only. For example, the Tokyo Stock Exchange (TSE) is the home stock market to firms such as Toyota, Sony, and Canon. The TSE is the major vehicle through which some 2,000 Japanese firms raise capital to fund their business activities. Several foreign companies, such as BP and Chrysler, are also listed on the TSE. Today, MNEs often list on a number of exchanges worldwide to maximize their ability to raise capital.

The character of markets varies worldwide. For example, the majority of the shares in the Japanese market are held by corporations, while in Britain and the United States shares are held much more by individuals. Despite these differences, stock exchanges are being increasingly integrated into a global securities market.

Bonds are another type of security sold through banks and stockbrokers. They are a form of debt that corporations and governments incur by issuing interest-bearing certificates in order to raise capital. Bonds enable the issuer to finance long-term investments. For example, SK Telekom, the main wireless communications provider in South Korea, financed much of its operations by selling bonds in the global market.



Several European telecommunications providers, such as Telecom Italia, Deutsche Telecom, and France Telecom, issued international bonds to fund their activities.<sup>15</sup>

In many national stock and bond markets, the most important players today are the *institutional investors*—managers of pensions and mutual funds, as well as insurance companies. They have now assumed an enormous role in driving capital markets around the world. As an example, the Government Pension Investment Fund of Japan, one of the world's largest, has over \$1 trillion of assets.

## Commercial Banks

Banks are important players in the global financial sector. They store deposits and extend credit to households and firms. A bank raises funds by attracting deposits, borrowing money in the interbank market, or issuing financial instruments in the global money market or securities markets. Commercial banks—Bank of America, Mizuho Bank in Japan, and BBVA in Spain—are the foot soldiers of the international monetary system. They, more than any other institution, circulate money and engage in a wide range of international financial transactions. Banks are regulated by national and local governments, which have a strong interest in ensuring the solvency of their national banking system.

The many types of banks and their primary activities include:

- *Investment banks* underwrite—guarantee the sale of—stock and bond issues and advise on mergers, such as the merger of Goldman Sachs in the United States and Nomura Securities in Japan. Read this chapter's *Recent Grad in IB* feature, which highlights Chip Besse, who works in investment banking in Europe.
- *Merchant banks* provide capital to firms in the form of shares rather than loans. They are essentially investment banks especially equipped to handle international operations. The Arab-Malaysian Merchant Bank is an example.
- *Private banks* manage the assets of the very rich. Union Bank in Switzerland (UBS) and ABN AMRO Private Banking in Luxembourg are examples.
- *Offshore banks* are located in jurisdictions with low taxation and regulation, such as Switzerland or Bermuda. Banco General in Panama and Bank of Nova Scotia in the British Virgin Islands are examples.
- *Commercial banks* deal mainly with corporations or large businesses. Credit Lyonnais in France and Bank of America are examples.

In late 2006, nine foreign banks took a key step toward breaking into the Chinese retail banking industry, receiving permission to become the first international lenders to incorporate in China under World Trade Organization market-opening pledges. Here, Citibank of the United States is pictured in Shanghai.



For firms, the most important functions of banks are to lend money to finance business activity, play a key role in nations' money supplies, and exchange foreign currencies. The major world banking centers are London, New York, Tokyo, Frankfurt, and Singapore, with London having the greatest concentration of international banks in the world. Many banks are MNEs themselves, such as Citibank, Britain's HSBC, and Spain's BBVA. Smaller banks participate in international business by interacting with larger, *correspondent banks* abroad. A correspondent bank is a large bank that maintains relations with other banks around the world to facilitate international banking transactions.

## > RECENT GRAD IN IB Chip Besse



**C**hip Besse is a natural entrepreneur. He started a waste management company while he was in college. Chip realized early that he wanted a career in finance. In his junior year, he obtained a 10-month internship with Merrill Lynch, the investment broker, where he assisted with quarterly reports on restructuring client portfolios. Chip studied on his own and became well versed in insurance sales and variable investment annuities.

In his senior year, Chip studied abroad for a semester in Valencia, Spain. The experience opened his eyes to the possibilities of an international career. A campus visit from an international bank executive motivated Chip further. He contacted the banker via e-mail and telephone for several months until, impressed by his persistence, she offered him an internship at the large international bank where she worked in London.

Chip's hard work so impressed his superiors that they let him enroll in the bank's Graduate Training Program, where he learned how to build financial models for managed buy-outs (MBOs) and leveraged buy-outs (LBOs), as well as mergers and acquisitions. Chip's work involved him in deals to buy companies, make them more profitable, and then sell them. He worked with a team that closed deals throughout Europe, the Middle East, and the United States. Chip's experience accumulated as he assisted in soliciting funds from equity investors and banks. He made numerous presentations to credit committees and transaction management teams. He researched financial data on acquisition targets in various sectors. He devised a system

for monitoring budget variances on ongoing investments.

Chip's group acquired underperforming firms and restructured their strategies, with the aim of making them leading industry players. For example, Chip worked on a deal in Scandinavia to refocus a family-run firm that was losing money. Chip and his group helped negotiate a divestment of the firm, cut costs, and devised various growth strategies. Through the efforts of his team, the firm brought in proceeds from divestment of nearly \$150 million and increased its profit margin from 2 to 9 percent.

In Britain, Chip worked on the LBO of a movie-theatre chain worth over \$800 million. His assignments included financial modeling of the acquisition, refinancing, and optimizing the firm's capital structure. Chip negotiated with lawyers, accountants, and trade partners. In Central America, he negotiated an LBO for a solid-waste removal firm. He worked on a \$30 million debt and equity fundraising deal for an Eastern European startup, also in the waste management business, and a \$600 million acquisition of a European sporting company.

After spending over a year at the bank, Chip joined his managing director and colleagues in establishing a new investment firm. In its first year, the firm acquired three companies in Europe and investigated various opportunities in North and South America, Eastern Europe, and Asia. In his spare time, Chip obtained certification in advanced financial modeling, corporate valuations, and the advanced analysis of financial statements.

**Chip's majors:** Bachelor's degree in Finance with a minor in Spanish

**Objectives:** Adventure, international perspective, career growth, self-understanding, and the opportunity to learn foreign languages

**Internships during college:** Merrill Lynch investment broker

**Jobs held since graduating:**

- A major bank in London
- A new investment firm in London

### Success Factors for a Career in International Business

"I enjoy learning about new cultures and assessing investment opportunities where the common variables change drastically. My work requires an eclectic skill base. We often deal with political risk, currency risk, and cultural risk. We try to mitigate most of the risks by doing our homework, talking to local people, immersing ourselves in the culture, and being really diligent by visiting all the locations. There is no 'normal' day at the office."

### Challenges

"I recommend a career in international business [even though] doing business in another country and living away from your family and friends is not easy. It takes an open mind, much hard work, and persistence."

Banking practices vary widely. In some countries, banks are owned by the state and are extensions of government. In other countries, banks face little regulation and may lack safety nets that might prevent their failure. In developing economies, private banks are usually subject to substantial government regulation.

Another distinction among national banking practices is the density of banks in individual countries. For example, Canada, Sweden, and the Netherlands each has only five banks controlling more than 80 percent of all banking assets. In Germany, Italy, and the United States, by contrast, the top five banks control less than 30 percent of all banking assets. Banks also charge different rates for their services. For a typical customer, the annual price of core banking services in Italy is over \$300, and \$150 in the United States. However, the annual price is about only \$50 in China and the Netherlands.<sup>16</sup>

## Central Banks

As the official national bank of each country, the central bank regulates the money supply and credit, issues currency, and manages the rate of exchange. The central bank also controls the amount of financial reserves held by private banks. It implements monetary policy by increasing or decreasing the money supply through one of the following methods: (1) buying and selling money in the banking system, (2) increasing or decreasing the interest rates on funds loaned to commercial banks, or (3) buying and selling government securities. The central bank may also function as the lender of last resort in the event of a financial crisis. Examples of central banks include the Reserve Bank of India, the Bank of England, the Banque de France, the Bank of Japan, and the Federal Reserve Bank in the United States.

As an example, the Federal Reserve Bank of the United States, also known as the Fed, formulates and conducts U.S. monetary policy by influencing the money supply and credit conditions in the U.S. economy. The Fed's main goal is to keep inflation low. A central bank conducts **monetary intervention**, which involves buying and selling government securities to maintain a certain exchange rate of its currency. For example, if the Fed wants to support the value of the U.S. dollar, it might buy dollars in the foreign exchange market. The Fed supervises and regulates the nation's banking system to ensure the safety and soundness of the national financial system. The Fed also works with the International Monetary Fund, the Bank for International Settlements, the Organisation for Economic Cooperation and Development (OECD), and other international agencies to ensure sound international monetary and financial policies in global markets.

**Monetary intervention** The buying and selling of government securities by a central bank to maintain the exchange rate of a country's currency at some acceptable level.

## The Bank for International Settlements

The Bank for International Settlements (BIS) is an international organization established in 1930 and based in Basel, Switzerland. The mission of the BIS is to foster cooperation among central banks and other governmental agencies, with the aim of supporting stability in the global monetary and financial systems. The BIS provides banking services to central banks and assists them in devising sound monetary policy. It attempts to ensure that central banks maintain reserve assets and capital/asset ratios above prescribed international minimums. Assisting countries to maintain these minimums is important because it helps governments avoid becoming too indebted. Maintaining adequate capital is prescribed by the Basel Capital Accord, originally promulgated by the BIS.<sup>17</sup>

## International Monetary Fund

Headquartered in Washington, D.C., the International Monetary Fund (IMF) provides the framework and determines the code of behavior for the international monetary system. The agency promotes international monetary cooperation, exchange rate stability, and orderly exchange arrangements. It also encourages

countries to adopt sound economic policies. These functions are critical, because economic crises can destroy jobs, slash incomes, and cause human suffering.

Governed today by 184 countries, the IMF stands ready to provide financial assistance in the form of loans and grants to support policy programs intended to correct macroeconomic problems. For instance, during the 1997–1998 Asian financial crisis, the IMF pledged \$21 billion to assist South Korea to reform its economy, restructure its financial and corporate sectors, and recover from recession.<sup>18</sup>

To help manage currency valuation worldwide, the IMF established a special type of international reserve known as the **Special Drawing Right (SDR)**. The SDR is a unit of account or a reserve asset, a type of currency used by central banks to supplement their existing reserves in transactions with the IMF and to manage international exchange rates. For example, a central bank might use SDRs to purchase foreign currencies to manage the value of its currency on world markets. The value of the SDR is very stable because it is based on a basket of currencies—the euro, the Japanese yen, the U.K. pound, and the U.S. dollar.

The IMF plays an important role in addressing financial and monetary crises faced by nations around the world. Typical crises fall into three major categories.

A *currency crisis* results when the value of a nation's currency depreciates sharply or when its central bank must expend substantial reserves to defend the value of its currency, thereby pushing up interest rates. Currency crises occur more commonly in smaller countries, and are sometimes the result of a sudden loss of confidence in the national economy or speculative buying and selling of the nation's currency.

A *banking crisis* results when domestic and foreign investors lose confidence in a nation's banking system, leading to widespread withdrawals of funds from banks and other financial institutions. This situation arose in the United States in the 1930s when, during the Great Depression, millions of people panicked about their savings and rushed to withdraw funds from their bank accounts. The crisis led to the failure of numerous banks. Banking crises tend to occur in developing economies with inadequate regulatory and institutional frameworks. These crises can lead to other problems, such as exchange rate fluctuations, inflation, abrupt withdrawal of FDI funds, and general economic instability.

A *foreign debt crisis* arises when a national government borrows an excessive amount of money from banks or by selling government bonds. For example, China's total foreign debt now exceeds \$200 billion. However, the debt is manageable because China has a huge reserve of foreign exchange. By contrast, Argentina's foreign debt has reached roughly 150 percent of the country's GDP. In the effort to pay off the debt, financial and other resources are used that might be otherwise used for investing in more important national priorities. Governments thus draw huge sums out of the national money supply, which reduces the availability of these funds to consumers and to firms attempting to finance business activities.

The IMF assists countries to resolve crises by offering technical assistance and training. It provides assistance by setting fiscal policy, monetary and exchange rate policies, and supervising and regulating banking and financial systems. The IMF also provides loans to help distressed countries in recovery. However, the international agency is frequently criticized because its prescriptions often require national governments to undertake reforms that are painful, at least in the short run. For example, the IMF may recommend that state economic enterprises should be downsized and workers laid off. Or, the government should give up subsidies or price supports for basic commodities. Some critics charge that the IMF harms countries by imposing too much austerity on them in

### Special Drawing Right

**(SDR)** A unit of account or a reserve asset, a type of currency used by central banks to supplement their existing reserves in transactions with the IMF.

Officials of the International Monetary Fund meet to address the needs of developing economies in international monetary affairs. The IMF promotes exchange rate stability and sound economic policies worldwide.





times of financial distress. The IMF argues that any country in an economic crisis usually must undergo substantial restructuring, such as the deregulation of national industries or privatization of state enterprises. However, it is sometimes difficult to pinpoint to what extent IMF prescriptions cause more harm than good.

### **World Bank**

Originally known as the International Bank for Reconstruction and Development, the initial purpose of the World Bank was to provide funding for the reconstruction of Japan and Europe following World War II. Today the World Bank aims to reduce world poverty and is active in a range of development projects to bring water, electricity, and transportation infrastructure. Headquartered in Washington, D.C., the World Bank is a specialized agency of the United Nations and has more than 100 offices worldwide. It is supported by some 184 member countries that are jointly responsible for how the institution is financed and how its money is spent.

The World Bank consists of a collection of subagencies that oversee various international development activities. The International Development Association loans billions of dollars each year to the world's poorest countries. The International Finance Corporation works with the private sector to promote economic development. It invests in sustainable private enterprises in developing countries and provides equity, loans, loan guarantees, risk management products, and advisory services to needful clients. The Multilateral Investment Guarantee Agency aims to encourage FDI to developing countries by providing guarantees to foreign investors against losses caused by noncommercial risks.

The IMF and the World Bank often work together. While the IMF focuses on countries' economic performance, the World Bank emphasizes longer-term development and the reduction of poverty. While the IMF makes short-term loans to help stabilize foreign exchange, the World Bank makes long-term loans to promote economic development.

## The European Union and the Euro

The European Union (EU) was established in 1993, an outgrowth of regional integration efforts in Europe since the 1950s. In the intervening years, other countries have joined, bringing the total to 27 member states in 2007. The EU's main objectives are to establish pan-European citizenship and assert Europe's economic and political role in the world. In 1989, the EU began to move toward the goal of a monetary union. The members created the European Monetary Union (EMU), which established a common currency, the euro. In 1998, the European Central Bank (ECB) was established in Germany. In 1999, the euro became the currency for large transactions of 11 EU member states, and euro banknotes and coins were issued in 2002, replacing traditional currencies such as the French franc and the German mark. As of 2007, 13 member states in the EU had adopted the euro. Illustrated in the exhibit below, these member states are: Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Slovenia, and Spain. Note that Denmark, Sweden and the United Kingdom are still not participating in the monetary union.

Sharing a single currency helps knit together the euro zone economies into a unified whole, eliminates

exchange fluctuations, and simplifies trade. It is easy to compare the spectrum of prices, taxes, and required pension contributions across national borders, and thus, businesses are tempted to make new investments in countries where costs are lowest and regulation is lightest. Member governments are under continuous pressure in the EMU to cut taxes, trim red tape, and harmonize fiscal and social policies. Harmonization implies that the governments are attempting to make these policies as similar as possible, throughout all the EU member states. For example, the governments are harmonizing product standards and regulations that govern business practices. They are coordinating their economic policies and jointly devising structural reforms that apply to all the EU countries.

### The Euro and Business

The introduction of the euro was a unique opportunity and a stimulus for European firms to rethink fundamentals about how they did business. Accounting transactions became cheaper and easier to carry out because there is only one currency to deal with. Firms had to undertake a range of operational preparations,



Euro Zone Member Countries

particularly regarding financial and accounting operations. For example, firms had to convert all accounts to the euro.

Managers at large multinationals favor the euro because it reduces the cost of doing business in many national markets, especially by removing the effect of currency fluctuations in cross-border trade and investment. The single currency makes the job of running an MNE much easier. U.S. and Japanese companies doing business in Europe now have fewer currency exchange hassles. With the move to a single currency, there are opportunities to reduce costs that benefit firms and their customers.

Many companies found that they had to radically modify their pricing strategies. For instance, computer maker Dell considered various strategies and ultimately decided to be a leader in harmonizing prices across the EU. Use of a single currency makes prices easier to compare, which increases competition in the EU. Firms like Dell had to standardize their pricing across Europe to prevent customers from shopping the continent and making their purchases in the country with the lowest price.

### Challenges for Policymakers

The ECB views the currency zone as one region, rather than as separate countries with different economic conditions. The problem is that when the countries tied themselves to the euro, their economies had not yet converged. Even today, very different economic and fiscal conditions exist among the nations that comprise the euro zone. Many countries—Belgium, France, Germany, Greece, and Italy, to name a few—have high national debts or high pension costs. For example, while the proportion of workers is declining in most countries, the number of retirees is increasing. Having fewer workers means fewer people paying taxes, which reduces options for financing national pension and retirement funds. When one country's economy is booming, with little debt and low unemployment, another country's economy may be stalled, with high unemployment. ECB governors attempt to devise monetary policy for all EU members, simultaneously, but the one-size-fits-all approach does not suit circumstances across such a wide range of national economic conditions.

Interest rates may be even more problematic. A key ECB mandate is to keep inflation at 2 percent or less. Governments seek to keep inflation low because it can discourage investment and saving, harm living standards, and complicate business planning. When the ECB cuts interest rates, banks borrow funds and more euros are released into the EU money supply. All else being equal, increasing the money supply can drive up inflation. Despite the 2-percent goal, the inflation rate varies widely across the member countries. Less-well-off countries in southern Europe, trying to catch up to wealthier countries like Germany, have inflation rates that are often above 3 percent. Inflation in

other countries can be below 1 percent, prompting fears of deflation, a decline in prices. Deflation is just as harmful to an economy as inflation. Deflation can cause large drops in GDP and reduce the value of assets and income.

Another risk faced by the European Union is asymmetric shock, an economic problem that afflicts one part of the euro zone much more than any other. When such an event occurs in a currency union, the policy response is difficult, because there is little scope for independent monetary or exchange rate management. For instance, if southern Europe experiences high inflation and northern Europe experiences deflation, ECB policy that aims to fix the problem in one region is likely to make it worse in another.

ECB policy has become especially challenging with the admission into the EU of poorer eastern European countries such as Poland and the Czech Republic, whose economies are much less stable than those in western Europe. As the number of diverse EU members rises, there is an ever-greater risk of asymmetric shocks. Compared to the original EU members, living standards in the new EU countries are low. Giving up the freedom to adjust interest rates, and accepting a monetary policy that may be either too tight or too slack, could hobble their progress toward attaining higher living standards.

As the currency of continental Europe, the euro has become a symbol of Europe's values and solidarity. But Britain, fearing the threat to its national autonomy, has opted not to join the monetary union, keeping the British pound as its currency. In a poll of senior British business executives, only 35 percent thought Britain should switch to the euro as soon as possible. A British decision to join the euro zone would be seen as a powerful vote of confidence in the euro. Conversely, the decision to stay out raises questions about the EU's official view—that the single currency is both historically inevitable and unarguably beneficial for all who adopt it.

### Appreciation of the Euro

If the value of the euro appreciates, it harms the foreign sales and profits of the EU's internationally active firms. A rising euro makes European products more expensive abroad, and therefore less competitive, or yields MNEs smaller earnings when they convert foreign profits into euros. The common currency was intended partly to help shield the euro bloc from currency shocks by creating a large, unified economy. Because Europe is more reliant on trade, however, the EU is still more sensitive to currency fluctuations than the United States. The ECB estimates that a one-year, 5 percent increase in the value of the euro can knock nearly 1 percent off annual GDP growth, several times the impact a similar rise in the dollar would have on the United States. The usual drawbacks of an appreciating currency, such as getting priced out of export markets, hits Europe faster and harder than it does Japan or the United States.

The euro was weak for the first several years of its existence, and the ECB fought the decline by intervening in foreign exchange markets. ECB monetary policy can do only so much for economies that remain burdened with high taxes and inflexible labor markets. For instance, in recent years, the rise of the euro against the dollar and the yen has resulted in falling international sales for European companies. A strong euro could cause problems for Europe's economy overall. It could even tip the continent into a full-blown recession—a risk that would prompt the ECB to cut interest rates. As a broad rule of thumb, a 10 percent rise in the value of the euro against the dollar causes a 3 percent fall in European corporate profits.

A moderate, controlled rise of the euro would theoretically make import prices cheaper and lower inflation, which could ease pressure on the ECB to raise interest rates. But inflation in Europe can drag down private consumption. There is one immediate advantage of a stronger euro: It helps squeeze inflation by cutting the price of imports, especially oil.

### The Euro's Unifying Effect

The success of the euro as a unifying force in Europe is gradually changing the international balance of power. European governments feel more empowered to challenge U.S. policy initiatives in the wider global arena. U.S. policymakers wonder whether the euro will challenge the dollar's dominance as the world's currency of choice for international trade. In their reserves of foreign currencies, the central banks of many countries—including Canada, China, and Russia—are giving more weight to the euro. The European currency's position in global foreign currency reserves is growing, eroding the power of the dollar. Many governments are increasing their euro holdings, and Asia is now significantly less dollar-centric than in the past.

## AACSB: Reflective Thinking

### Case Questions

1. What types of challenges did European firms face in doing business across borders prior to adopting the euro? What types of changes did these firms make once the euro became the new currency?
2. What types of competitive advantages and disadvantages are associated with the implementation of the euro from the perspective of the firm? Was adopting the euro worth it? Why or why not?
3. Elaborate on the following statement: "Because Europe is more reliant on trade, the EU is more sensitive to currency fluctuations than the United States." Why is the EU more sensitive to currency fluctuations?
4. What is the job of a central bank, like the ECB? What is meant by the term *asymmetric shock*? Why does the ECB have to implement a one-size-fits-all monetary policy? What are the challenges and disadvantages of such a policy?
5. Why did Britain opt out of joining the euro zone? What are the potential advantages and disadvantages for Britain of being in the euro zone? 

Sources: Bucci, G., and C. James. (1997). The implications of being in and out of the single European currency. *Credit Control* 18(2): 21–26; *Economist*. (2003). "Finance and Economics: Germany's Euro Test," June 14, p. 96; *Economist*. (2003). "Grappling with the Strong Euro," June 7, p. 65; Ellison, Sarah. (2002). "Revealing Price Disparities, the Euro Aids Bargain-Hunters," *Wall Street Journal*, Jan 30, p. A15; Fairlamb, D. (2003). "Super Euro: As the Currency Soars, Central Banks are Raising Their Holdings," *Business Week*, February 17, p. 54; Garnham, P. (2007). "Euro Close to Record High Against Dollar," *Financial Times*, April 26, p. 42; Marshall, M., and D. Wessel. (1997). "One Currency, One Central Bank, One Big Question" *Wall Street Journal*, May 2, p. A10; Read, T. (1997). "The Model of a Central Bank," *Euromoney*, August, pp. 55–56; Reed, S. (1997). "The Almighty Euro," *Business Week*, December 29, p. 114; Sesit, M. (2002). "Euro's Launch Helps Consumers Easily Compare Cost of Goods," *Wall Street Journal*, January 18, p. C11; Walker, M., and J. Perry. (2006). "Politics & Economics: Euro Zone Economy Shows More Self-Reliance," *Wall Street Journal*, December 1, p. A6.



# CHAPTER ESSENTIALS

## Key Terms

balance of payments, p. 293  
central bank, p. 291  
contagion, p. 297  
currency risk, p. 287  
devaluation, p. 293  
exchange rate, p. 286

foreign exchange, p. 288  
foreign exchange market, p. 288  
global financial system, p. 296  
International Monetary Fund (IMF),  
p. 295  
international monetary system, p. 296

monetary intervention, p. 302  
Special Drawing Right (SDR), p. 303  
trade surplus, p. 292  
trade deficit, p. 292  
World Bank, p. 295

## Summary

In this chapter, you learned about:

### 1. Currencies and exchange rates in international business

Much of international trade involves exchanging currencies, such as the dollar, euro, and yen. An **exchange rate** is the price of one currency expressed in terms of another. **Currency risk** arises from the changes in the price of one currency relative to another. As exchange rates fluctuate, so do firms' international business prospects. A *convertible currency* is one that can be readily exchanged for other currencies. Some currencies are *nonconvertible* and not readily exchangeable for other currencies. **Foreign exchange** refers to all forms of money that are traded internationally, including foreign currencies, bank deposits, checks, and electronic transfers. *Capital flight* refers to the tendency of international investors to drastically reduce their investments in a currency that is losing its value. Currencies are exchanged in the **foreign exchange market**—the global marketplace for buying and selling currencies—mainly by banks and governments.

### 2. How exchange rates are determined

The relative values of currencies are determined by various factors. First is *economic growth*, the increase in value of the products and services produced by a country. A second factor is inflation, which is closely related to interest rates. As inflation rises, so do interest rates. This tendency is usually accompanied by a decrease in the value of the involved currency. A third determinant of exchange rates is *market psychology*, the often unpredictable behavior of investors, especially when acting en masse. Finally, governments play a major role in influencing exchange rates. **Trade deficit** refers to the amount by which a nation's imports exceed its exports for a specific period of time. **Trade surplus** is the amount by which a nation's exports exceed its imports for a specific period of time. Government action to influence exchange rates is broadly termed **monetary intervention**. When the action aims to lower the currency's value, the result is a **devaluation**—government action to reduce the official value of its currency, rela-

tive to other currencies. The **balance of payments** is the annual accounting of *all* economic transactions of a nation with all other nations.

### 3. Development of the modern exchange rate system

The evolution of the modern exchange rate system began with the Bretton Woods agreement in 1944, which aimed to stabilize exchange rates worldwide. But the system collapsed in 1971 as currency values were allowed to begin floating according to market forces. Currently, the value of major world currencies is based on a *floating exchange rate system*, as determined by market forces. However, some developing economies apply a *fixed exchange rate system* in which the value of the national currency is permanently pegged or set to the value of one or more other currencies.

### 4. The international monetary and financial systems

The **international monetary system** refers to the institutional framework, rules, and procedures by which national currencies are exchanged for each other. It includes institutional arrangements that countries put in place to govern exchange rates. The system includes the foreign exchange market as well as the central banks of each nation, national treasuries, commercial banks, and supranational agencies, such as the International Monetary Fund and World Bank. The **global financial system** is the collective of financial institutions that facilitate and regulate investment and capital flows worldwide, such as central banks, commercial banks, and national stock exchanges. It reflects the activities of companies, banks, and financial institutions, all engaged in ongoing financial activity. The system includes national and international banking systems, the international bond market, the collective of national stock markets, and the market of bank deposits denominated in foreign currencies. The global financial system now facilitates massive trading of financial assets and currencies. It also gives rise to **contagion**, the tendency of a financial or monetary crisis in one country to spread rapidly to other countries.

## 5. Key players in the monetary and financial systems

Key participants include firms that acquire large quantities of foreign exchange in the course of international business. These firms engage in various investment activities abroad that generate revenues and inject money into the financial system. Nations also have *national stock exchanges* and bond markets in which securities and bond trading takes place. There are various categories of banks, which perform a range of functions. Each country has a **central bank**—the monetary authority that regulates the money supply and credit, issues currency, and manages the rate of exchange. It is usually the lender of last resort, and controls the monetary policy and levels of foreign exchange within national

economies. The **World Bank** is an international agency that provides loans and technical assistance to low and middle-income countries with the goal of reducing poverty. The **International Monetary Fund (IMF)** is a key international agency that aims to stabilize currencies by monitoring the foreign exchange systems of member countries and lending money to developing economies. The IMF employs **special drawing rights**, a type of international reserve, to help manage currency valuation worldwide. A *currency crisis* results when the value of the nation's currency depreciates sharply. A *banking crisis* results when investors lose confidence in a nation's banking system and massively withdraw funds. Excessive *foreign debt* can harm the stability of national financial systems.

## Test Your Comprehension AACSB: Reflective Thinking

1. Distinguish the terms exchange rate and foreign exchange. What does each term mean?
2. Distinguish between convertible and nonconvertible currencies.
3. Exchange rates fluctuate constantly. What is the effect of this on companies engaged in cross-border transactions?
4. Summarize the four major factors that determine exchange rates.
5. What is the relationship between inflation, interest rates, and currency values?
6. What was the Bretton Woods agreement, and what is the legacy of Bretton Woods for international trade today?
7. Distinguish the two systems that make up the exchange rate system today.
8. What is the difference between the international monetary system and the global financial system?
9. What are the implications of contagion for the global economy today?
10. What are the key players in the international monetary and financial systems?
11. What are the aims of the World Bank and the International Monetary Fund?

## Apply Your Understanding

### AACSB: Reflective Thinking, Analytical Skills, Ethical Reasoning

1. Everest Company has been exporting its line of mountain-climbing equipment to distributors around the world since the late 1970s. Top markets have been France, Norway, Switzerland, India, and Japan. Everest's customers in these countries always pay in their local currency. Everest's vice president for international sales often states that the firm's biggest day-to-day challenge is dealing with foreign currencies. Why does he say this? What are the consequences of fluctuating exchange rates for Everest's sales revenue and other performance indicators?
2. Every nation has a government that implements monetary and fiscal policies. Monetary policy primarily involves management of the nation's money supply to achieve specific goals—such as constraining inflation and achieving full employment. How does a nation carry out monetary policy? What are the policy instruments that central bankers employ to alter the money supply? Central bankers go to much effort to devise sound monetary policies. Why do they do this? Why is it important to have sound monetary policies? What is the role of monetary policy in facilitating international trade?
3. The balance of trade is the nation's balance sheet of trade with the rest of the world. It represents the difference between the monetary value of a nation's exports and its imports. Some experts believe that a large trade deficit is harmful or may be a sign of economic problems. Do you agree? The United States has run a large trade deficit for many years. What are the long-term consequences of this trend for the United States?

### **AACSB: Communication, Reflective Thinking**

Refer to Chapter 1, page 27, for instructions on how to access and use globalEDGE.™

1. There are numerous foreign exchange calculators on the Internet, such as [www.x-rates.com](http://www.x-rates.com). You can find them via globalEDGE™ or by entering the keywords "exchange rate" into a Google search. Visit one of these calculators and compare the exchange rates of various currencies, including the dollar, euro, yen, and renminbi. What is the rate for these currencies today? What was the euro-dollar exchange rate one year ago? What factors might have caused the fluctuation in this rate during the year? Does this Web site provide a way to trade foreign currencies? What is the amount of commission or other fees charged?
2. Assume that you are a manager at a firm interested in entering Russia. As part of your initial analysis, top management would like to know about the level of currency and financial risks associated with the Russian market. Using

globalEDGE™ resources, write a short report on the current status of these risks, as well as the state of the Russian financial system and historical exchange rate stability. Based on your findings, what would your recommendation be?

3. The International Monetary Fund (IMF) lists its purposes as follows: (1) to promote international monetary cooperation via consultation and collaboration on international monetary problems; (2) to facilitate the expansion and balanced growth of international trade; and (3) to promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation. Visit the IMF Web site ([www.imf.org](http://www.imf.org)) and list several examples of how the IMF undertakes and accomplishes these goals. What kinds of specific actions has the IMF taken over the past year in order to address economic or financial crises of various nations?



## Identifying the Best Location for a Bank Branch Abroad

Banks are a leading participant in the global economy. They provide capital, foreign exchange, and money for national economies. Banks are reaching out to extend their operations to new markets around the world. Branch banking is a relatively inexpensive way to enter foreign markets, and the rise of international branch banking is part of the globalization of finance. Branch banking involves the bank in opening branches in the countries where the bank seeks to do business.

### AACSB: Reflective Thinking, Analytical Skills

#### Managerial Challenge

The problem of choosing the best markets for locating bank branches abroad is complex. What makes a good location? What types of indicators should be considered? In advance of locating bank branches abroad, management should try to ascertain the most appropriate location to maximize bank performance. The successful international manager investigates the best locations in advance. Given the number of potential locations and the variables to consider, decisions about the best foreign locations can be challenging.

#### Background

Banks' international lending and borrowing activities have led to increased cross-border capital flows. Banks have developed new types of financial instruments and investment vehicles that increasing numbers of firms and depositors worldwide find attractive. Larger banks often establish foreign branches, providing essentially the same financial services as local banks abroad. The international business environment entails various risks, and when banks set up branches abroad, they seek to maximize conditions for success and to minimize risk.

#### Managerial Skills You Will Gain

In this C/K/R Management Skill Builder©, as a prospective manager, you will:

1. Learn how to research key monetary and financial statistics on international markets.
2. Develop skills to identify factors to consider when locating bank branches abroad.
3. Learn how these factors relate to maximizing banks' performance and competitive advantages abroad.

#### Your Task

Assume you are a manager at Citibank, Barclays, or some other large bank. Management wants to set up additional bank branches abroad. Your task is to identify the most appropriate foreign location for setting up a bank branch. Based on your analysis, you should make a recommendation on which countries are most promising.

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