Test Yourself: International Finance

If you don't have a functioning financial system the world economy won't be revived. All the major economies have their responsibility to assist at a pace which is required to clean up the balance sheet of the banking system and to ensure that credit flows are resumed.

Manmohan Singh

What is a financial system?

A financial system refers to a set of components and mechanisms, such as monetary policies, insurance and banks, that allows economic transactions to occur.

What kinds of international financial institutions are there?

There are several types of international financial institutions including:

- multilateral development banks
- Bretton Woods institutions
- regional development banks
- bilateral development banks
- other regional financial institutions

What is the balance of trade?

The trade balance is the difference between a country's exports and imports of goods and services.

What is a trade deficit ?

A **trade deficit** is the amount by which the value of imports exceeds the value of exports in a given time period.

A US trade deficit represents a net outflow of dollars to the rest of the world.

What is a balance of payments?

The **balance of payments** is a summary of a country's international economic transactions in a given period of time.

It is an accounting statement of all international money flows in a given time period.

A balance of payments always equals zero … the current account deficit should equal the capital account surplus.

U.S. BALANCE OF PAYMENTS (HYPOTHETICAL)			
Current Account			
Goods exports	$30		
Goods imports	–$50		
Balance on goods (merchandise)		*–$20*	
Service exports	$18		
Service imports	–$12		
Balance on services		*$6*	
Balance on goods and service		*–$14*	Note: This negative balance indicates a trade deficit in goods and services.
Net investment income	–$5		
Net transfers	–$7		
Balance on current account		*–$26*	
Capital (or Financial) Account			
Inflow of foreign assets to U.S.	$35		
Outflow of U.S. assets abroad	–$20		
Balance on capital account		*$15*	
Official Reserves Account			
Official reserves		*$11*	
		$0	

Example: Balance of Payments

What is a current account?

A current account is the first section of a balance of payments, which includes trade in currently produced goods and services.

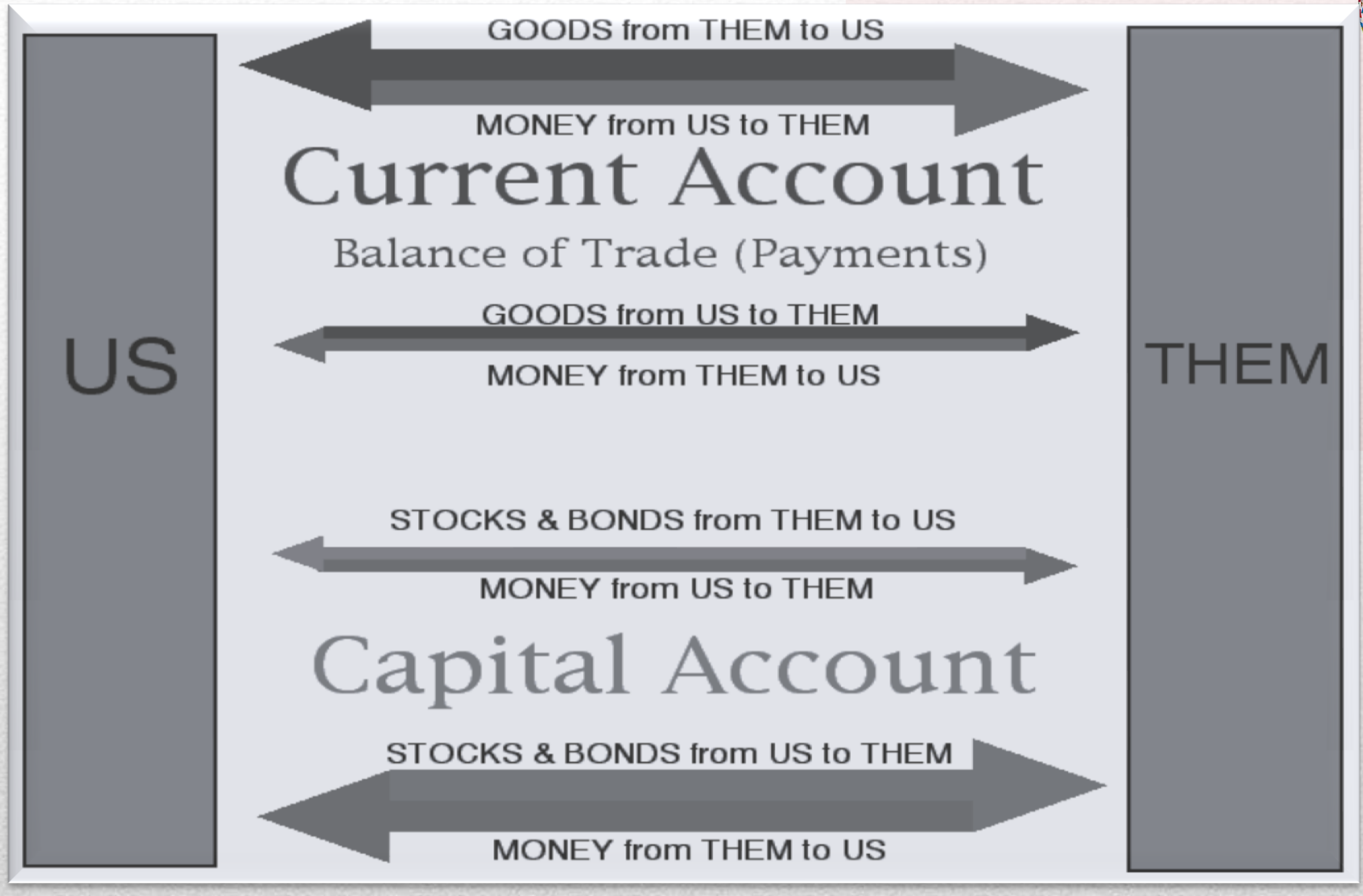
The current account is the most comprehensive summary of trade relations.

A current account deficit is financed by a capital account surplus.

What is a capital account?

A capital account is the second section of a balance of payments and records **payment** flows of financial capital.

The capital account takes into consideration assets bought and sold across international borders.



Comparing Current and Capital Accounts

	Credits	Debits
Current Account		
Exports	$ 1,418.64	
Imports		$ -1,809.18
Unilateral Transfers	$ 10.24	$ -64.39
Balance on current account		$ -444.69
Capital Account		
Direct Investment	$ 287.68	$ -152.44
Portfolio Investment	$ 474.39	$ -124.94
Other Investment	$ 262.64	$ -303.27
Balance on capital account	$ 444.26	
Statistical Discrepancies	$ 0.73	
Overall Balance	$ 0.30	
Official reserve account		$ -0.30

In 2000, the U.S. imported more than it exported, thus running a current account deficit of $444.69 billion.

During the same year, the U.S. attracted net investment of $444.26 billion—clearly the rest of the world found the U.S. to be a good place to invest.

In the real world, there is a statistical discrepancy.

Example: Current and Capital Accounts

What is the World Trade Organization?

The World Trade Organization plays a crucial role in the global financial system. The organization was created to establish and enforce rules of trade between nations. The World Trade Organization settles trade disputes and negotiates international trade agreements in its rounds of talks.

Among the various functions of the WTO, these are regarded by analysts as the most important: It oversees the implementation, administration and operation of the covered agreements and provides a forum for negotiations and for settling disputes.

What is an exchange rate?

An exchange rate is the amount of one nation's currency that equals one unit of another nation's currency.

For example, if $1.81 is exchangeable for £1 (British pound), the exchange rate is:

1 / 1.81 = .552 pounds per dollar

The supply and demand for foreign currency determine the exchange rate.

What determines the exchange rate of a currency?

The exchange rate is determined by demand and supply in the forex (foreign exchange) markets where traders buy and sell currencies.

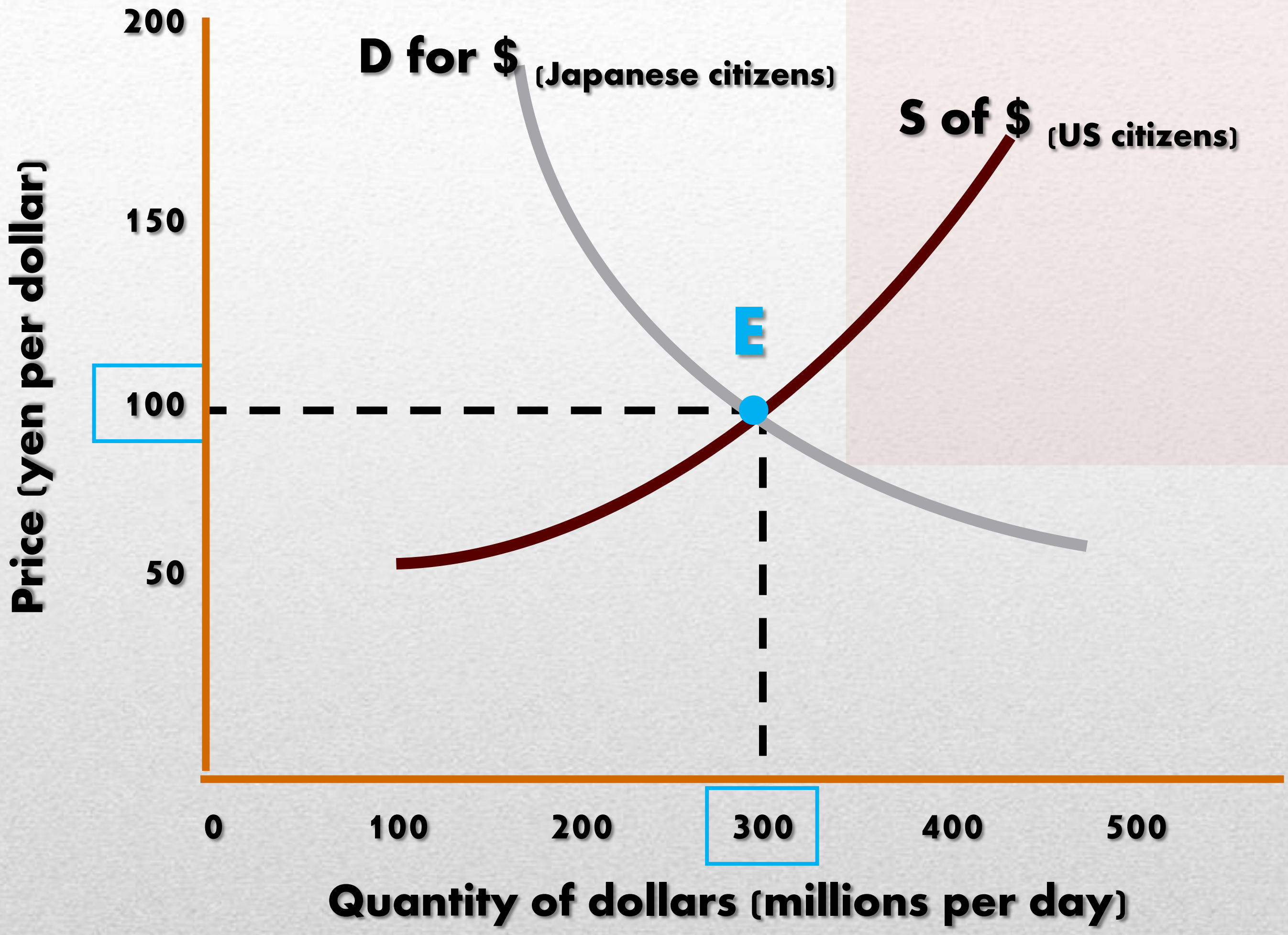


Chart: Supply and Demand for Dollars

What is the equilibrium price of currency?

The equilibrium price of a currency is the price at which the quantity of the currency demanded in a given time period equals the quantity of that currency supplied.

What was the Bretton Woods system?

The Bretton Woods system was an agreement that fixed the exchange rates that governed international financial relationships from the period after World War II until 1971.

What two international institutions did the Bretton Woods system establish?

The Bretton Woods system established

- the International Monetary Fund (IMF), which arranges short-term loans between countries.
- the World Bank, which makes longer-term loans to developing countries.

What is the International Monetary Fund ?

The International Monetary Fund (IMF) is an international organization headquartered in the United States which promotes the maintenance of a healthy global economy.

There are 185 member nations in the IMF, which means that almost every country in the world is in the IMF, and the handful of countries which do not belong are usually represented indirectly.

What is the World Bank?

The World Bank was created by the United Nations in an effort to eradicate poverty in poor countries. In addition to financial resources, the World Bank also lends technical expertise to help countries progress in areas of education, infrastructure, communications and health.

The World Bank aims to provide funding, take up credit risk or offer favorable terms to development projects mostly in developing countries that couldn't be obtained by the private sector.

To avoid the problems caused by fluctuating exchange rates, governments sometimes intervene to fix exchange rates by buying and selling currency.

How do they do that?

If a government *buys* its own currency, it can *increase* its exchange rate.

If a government *sells* its own currency, its value *decreases*.

What is Currency Stabilization?

Currency stabilization is the buying and selling of a currency by the government to offset temporary fluctuations in supply and demand for currencies.

The government is not trying to change the long-run equilibrium, but is trying to keep the exchange rate at that long-run equilibrium.

What is Purchasing Power Parity?

Purchasing power parity is a method of calculating exchange rates that values currencies at rates such that each currency will buy an equal basket of goods.

How did you do?! If you didn't do as well as you'd like, review the margin notes and presentations and test yourself again.

CONTINUED IN
TEST YOURSELF: EXCHANGE RATES