

Chapter 39 / 37

International Finance

Chapter Objectives

After you have studied this chapter, you should be able to discuss the advantages and disadvantages of fixed and flexible systems of international payments; the problems encountered when currency flows or exchange controls are used to maintain exchange rates at nonequilibrium values; explain the persistence of U.S. balance of trade deficits; and describe some possible reasons for the decline of the dollar from a position of undisputed primacy as the world's medium of exchange.

Chapter Review: Key Points

1. No world currency exists, so the value of each national currency in terms of all others must be established. The *exchange rate* is the value of one currency in terms of another.
2. *Balance of payments* accounts record the flows of money into and out of a country and provide information about trade relationships among countries.
3. *Flexible*, or *floating*, systems of *exchange rates* permit the values of currencies to be set by market forces. If a country experiences a balance of trade *surplus* (*deficit*) under such a system, it is an indication that the country's citizens or government (*foreigners*) desire foreign (*domestic*) currencies.
4. A *fixed* exchange rate system imposes price ceilings and floors on currencies, often resulting in persistent disequilibria in balances of payments.
5. Explanations for the decline of the dollar in the 1970s range from relative inflation to expectations of continued inflation and balance of trade deficits to federal budget deficits to the emergence of other strong international currencies to the cartelization of oil to too rapid monetary growth. Opposite trends then strengthened the dollar until 1985. Each of these explanations bears the germ of truth, but none alone is adequate to explain the dance of the dollar.

Matching Key Terms and Concepts

Set I

- ___ 1. “dirty” float
 - ___ 2. gold standard
 - ___ 3. balance of trade
 - ___ 4. nominal exchange rates
 - ___ 5. appreciation
 - ___ 6. fixed exchange rates
 - ___ 7. depreciation
 - ___ 8. foreign exchange
 - ___ 9. balance of payments
 - ___ 10. flexible exchange rates
- a.** Most exchange rates are set by international agreement.
 - b.** Exports minus imports.
 - c.** When the value of one currency rises relative to others.
 - d.** Prices of currencies are set by market forces.
 - e.** A record of foreign exchange inflows and outflows.
 - f.** Foreign currencies, collectively.
 - g.** Fixed amounts of each currency exchange for given amounts of gold.
 - h.** Government intervention in a flexible exchange system.
 - i.** The prices of currencies relative to one another.
 - j.** When a currency’s value falls relative to others.

Set II

- ___ 1. devaluation
 - ___ 2. dollar surplus
 - ___ 3. relative inflation
 - ___ 4. international portfolio adjustments
 - ___ 5. oil imports
 - ___ 6. exchange controls
 - ___ 7. international supply of dollars
 - ___ 8. exchange risk
 - ___ 9. key currency
 - ___ 10. real exchange rate
- a.** Decline of the fixed value of one currency versus others.
 - b.** Governments allocate the foreign exchange available to pay for imports.
 - c.** A currency that is widely held internationally for transaction, precautionary, and asset reasons.
 - d.** Potential losses to exporters who agree to accept importers’ currency, or to importers who must pay in exporters’ currency.
 - e.** Relative price of foreign goods in terms of domestic goods.
 - f.** A classic explanation of currency depreciation.
 - g.** “Mirrors” the U.S. demand for foreign exchange.
 - h.** Replacing the dollar as the asset of a central bank with some other strong currency.
 - i.** Caused substantial increases in the international supplies of dollars in the 1970s.
 - j.** Identical with a shortage of foreign exchange.

True/False Questions

- ___ 1. The nominal exchange rate is the value of a currency in terms of itself.
- ___ 2. If the dollar value of imports exceeds the dollar value of exports, there is a deficit in our balance of trade.
- ___ 3. An international gold standard would be an example of a fixed exchange rate system.
- ___ 4. Under a flexible exchange rate system, currencies' relative prices are largely determined by markets.
- ___ 5. An international gold standard was established by the United Nations at the end of World War I.
- ___ 6. Foreigners demand dollars only to import U.S. goods or invest in the United States.
- ___ 7. Unlike other prices, exchange rates seldom change under a system of flexible exchange rates.
- ___ 8. As is true of markets for virtually all goods, flexible exchange rate systems tend to drive the prices of all currencies to the equilibrium rates at which supply and demand intersect.
- ___ 9. "Dirty floats" tend to hamper flexible exchange rates so that they change less than they otherwise might.
- ___ 10. Exchange controls create pressures for government corruption and black markets for foreign currencies.
- ___ 11. Governments can more independently conduct macroeconomic policies under a flexible than under a fixed exchange rate system.
- ___ 12. From the end of World War II until 1971, the U.S. dollar was the only major world currency consistently backed by gold, at least for purposes of international trade.
- ___ 13. The international acceptability of the U.S. dollar has been a major reason why the U.S. has been able to run large and persistent current account deficits from 1981 to the present.
- ___ 14. The absorption problem prevents countries from running persistent current account surpluses.
- ___ 15. In 1985, almost all of the dollars held by OPEC countries were exchanged for other currencies.
- ___ 16. International transactions demands for dollars arise because exporters in many countries view dollars as less prone to exchange risk than the currencies of their customers.
- ___ 17. International demands for dollars have enabled the United States to offset persistent payments deficits with trade surpluses.
- ___ 18. Other countries have been far more successful than the United States in reaping seignorage from international financial markets.

___19. Foreign loans by U.S. organizations have accounted for most of the recent surpluses in U.S. balances of payments.

___20. A “dirty float” occurs when foreign central banks buy dollars from international money markets and store the dollars in their vaults.

Standard Multiple Choice

Each question has a single best answer.

___ 1. A country that exports more than it imports experiences a:
a. capital account surplus.
b. deficit in its national budget.
c. balance of trade deficit.
d. deficit in its balance of payments.
e. balance of trade surplus.

___ 2. The major reason for Americans to demand foreign money is to:
a. add to collections of rare stamps and coins.
b. pay for imports or foreign investments.
c. profit from seignorage by printing dollars.
d. finance tourist visits to foreign countries.
e. avoid U.S. income tax liabilities.

___ 3. Americans demand foreign currencies by:
a. exporting capital goods.
b. supplying dollars.
c. running balance of trade surpluses.
d. creating shortages of U.S. currency.
e. following inflationary policies.

___ 4. A gold standard is an example of a:
a. fixed exchange rate system.
b. nondiscretionary “pegged” currency.
c. flexible exchange rate system.
d. “dirty float.”
e. “crawling peg” automatic stabilizer.

___ 5. Stocks of foreign currencies that have been received to cover international payments are:
a. gold coins and bullion.
b. foreign exchange.
c. international seignorage.
d. bills of lading.
e. international transfer payments.

___ 6. A currency’s price in terms of a foreign country’s currency is known as the:
a. nominal exchange rate.
b. terms of trade.
c. reciprocal value.
d. counter price.
e. par value.

- ___ 7. Currency revaluation under a gold standard would parallel:
- depreciation under a silver standard.
 - appreciation under a flexible exchange rates.
 - devaluation under fixed exchange rates.
 - recycling under an ecological system.
 - repricing costs in an inflationary system.
- ___ 8. A balance of trade surplus would be a likely symptom of or:
- international surpluses of the country's currency.
 - falling imports and rising exports.
 - contractionary policies by its trading partners.
 - shifting from a fixed to a floating exchange rate system.
 - overseas investments by domestic firms.
- ___ 9. Reversal of a trade deficit if all countries were on a gold standard might entail:
- revaluation of the country's currency relative to other currencies.
 - depreciation of the currency through normal market processes.
 - contractionary macroeconomic adjustments.
 - discoveries of new gold supplies in the deficit country.
 - decreasing Aggregate Demands in surplus countries.
- ___ 10. If American balance of trade deficits indicate disequilibrium, the markets for currencies of countries experiencing balance of trade surpluses are characterized by:
- shortages.
 - surpluses.
 - unusual scarcity.
 - overproduction.
 - excessive supply.
- ___ 11. Appreciation will eliminate a balance of trade surplus most rapidly when:
- foreign demands for a country's exports and domestic demands for imports are both extremely inelastic.
 - foreign demands for exports and domestic demands for imports are both elastic.
 - domestic exchange controls are rigid.
 - inflows of foreign exchange are used to pay for all foreign purchases.
 - none of the above.
- ___ 12. An American balance of trade deficit would tend to be balanced by:
- increased U.S. foreign aid programs.
 - increased imports by consumers.
 - greater levels of foreign investment by American corporations.
 - lower prices for imported goods that are elastically demanded by U.S. consumers.
 - greater foreign purchases of the bonds of American corporations.

- ___13. A substantial increase in the national income of a country will:
- cause a balance of trade surplus under a fixed exchange rate system.
 - generate pressure for the country's currency to be revalued upward.
 - cause its exports to increase dramatically.
 - cause devaluation under a flexible exchange rate system.
 - create pressure for the depreciation of the exchange rate of its currency.
- ___14. Since 1946, relative to the capital account in the U.S. balance of payments, our current account has:
- far more often been in deficit.
 - usually balanced or been in surplus.
 - reflected an excess of exports over imports.
 - declined because services are an increasing proportion of trade.
- ___15. The dollar's position as a key international currency has:
- allowed Americans to gain through seignorage by issuing international money.
 - been a major reason for loss of U.S. power and prestige.
 - stimulated growth of federal deficits.
 - driven our balance of trade into persistent surpluses.
 - dampened economic growth internationally.
- ___16. A hike in international oil prices will cause the dollar to fall more under a flexible exchange rate system if:
- foreigners believe that the FED will adapt to these hikes with expansionary monetary policies.
 - our demands for imports and foreign demands for our exports are both quite inelastic.
 - foreigners quickly lose faith in the dollar when its exchange rate falls even slightly.
 - other countries with strong currencies are less dependent on imported oil.
 - All of the above.
- ___17. Which of the following has not been offered seriously as an explanation for the 1970s decline of the dollar?
- OPEC petroleum price hikes.
 - expectations of continued relative inflation in the United States.
 - rapid increases in prices for gold.
 - overly expansionary U.S. monetary policy.
 - the increasing stability and acceptability of other currencies.
- ___18. Until roughly 1970, foreign central bankers could exchange:
- \$35 to the U.S. Treasury for an ounce of gold.
 - deficits in their balance of trade for U.S. Treasury bonds.
 - international loans at a fixed interest rate at the World Bank.
 - surpluses for silver certificates issued by the International Monetary Fund.
 - trade surpluses for United Nations payments.

- ___19. If exporters' currency appreciates, exchange risk losses could be imposed on:
- importers who insisted on paying in their own currency.
 - exporters who insisted on being paid in their own currency.
 - arbitraders who exploited price differentials between markets.
 - importers who agreed to pay in the exporters' currency.
 - speculators who had bought the exporters' currency earlier.
- ___20. Consistent U.S. balance of trade deficits are partially explained by:
- demands in unstable countries for economically stable currencies.
 - foreign governments bolstering growth by stimulating exports.
 - habits developed when the dollar was the only currency convertible to gold.
 - greater foreign demands for dollars than for American goods.
 - All of the above.

Chapter Review (Fill-In Questions)

- The price of one currency in terms of another is known as its _____. A country's exports minus its imports is its _____; a record of its inflows and outflows of funds is kept in its _____ account. Currencies received from sales of exports are known as _____.
- Under a(n) _____ exchange rate system, such as the _____ standard, balance of trade deficits can be accommodated by borrowing or drawing down previously accrued _____, or by the use of _____ controls, under which government allocates the foreign currencies that are available.
- One problem with _____ exchange rates is that international transactions create exchange risk; if the contract specifies payment in the _____ currency, exchange rate depreciation of that currency will cause the _____ to receive less than expected, while the importer will be forced to pay more than expected if the currency of the _____ is specified and the exchange rate of that currency appreciates. These problems can be finessed, however, if the traders negotiate a contract in either currency and then "buy insurance" against _____ by dealing in the _____ market for foreign exchange.
- In the past half century, the United States has persistently run _____ in its balance of trade. This has been possible because, internationally, the dollar has been a _____ currency. Foreigners have demanded dollars to facilitate transactions, even when American traders are not involved. Our relative political and economic stability have also caused foreigners to demand dollars for _____ and _____ reasons. The ability of the FED to issue "international money" has allowed Americans to reap _____ because of the huge difference between the _____ of dollars and their value in exchange.

Unlimited Multiple Choice

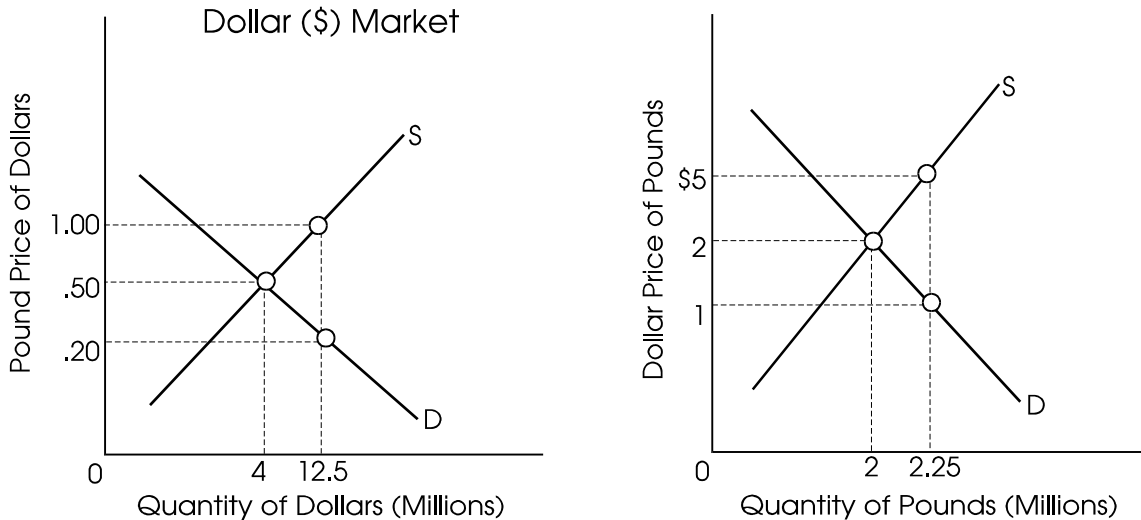
Each question has from zero to four correct responses.

- ___ 1. Balance of trade:
- deficits occur when a country's receipts of money from foreigners exceed its payments to foreigners.
 - use double-entry bookkeeping.
 - accounts record flows of funds among countries that trade.
 - surpluses occur when receipts of money from foreigners exceed a country's payments to foreigners.
- ___ 2. In a fixed exchange rate system, if a country's currency experiences:
- a surplus, then its balance of payments tends to be in surplus.
 - a shortage, then its balance of trade tends to be in surplus.
 - less demand by foreigners than it has demand for foreign exchange, then an international surplus of its currency occurs.
 - greater demand by foreigners than its demand for foreign exchange, an international shortage of its currency occurs.
- ___ 3. Fixed exchange rates:
- adjust more quickly than flexible exchange rates do to changes in relative supplies and demands for currencies.
 - pose no special problems as long as exchange rates reflect the true market values of currencies.
 - warp true values for all currencies.
 - are not problems as long as they parallel the values that would exist under flexible exchange rates.
- ___ 4. The United States has been able to run balance of trade deficits fairly consistently for almost four decades because dollars:
- are widely used as an international medium of exchange.
 - have been viewed as "insurance" in politically unstable countries.
 - have been supported at artificially high exchange rates by West Germany, Japan, etc., to boost U.S. demands for their exports (or, perhaps, to indirectly pay for U.S. provision of national defense).
 - create volatility in the exchange rates of monkey currencies.
- ___ 5. An increased American preference for Japanese goods:
- will manifest itself in a decreased American demand for the yen.
 - will manifest itself in an increased American supply of dollars in foreign exchange markets.
 - means that American importers of Japanese goods may be forced to pay higher dollar prices.
 - implies a depreciation of the yen in terms of the dollar.

Problems

Problem 1

Use this figure, which depicts markets for the U.S. dollar and the British pound, to answer the following questions.



- What is the equilibrium exchange rate of the dollar? _____
- What is the equilibrium exchange rate of the pound? _____
- What is the per unit (pound) price of a dollar? _____
- What is the per unit (dollar) price of a British pound? _____
- Explain why the U.S. demand for British pounds is downward sloping. _____
- Explain why the British supply of pounds is upward sloping. _____
- Suppose Americans purchase British goods valued at \$2 million. Americans demand _____ British pounds in equilibrium and supply _____ dollars.
- Assume the British manifest an increased preference for U.S. goods. Which curves will shift and why? _____ What happens to the British pound? _____ What happens to the dollar? _____ What happens to the pound price of American exports to Britain? _____ What happens to the dollar price of U.S. imports from Britain? _____

- i. Assume that the new equilibrium exchange rate is $\$1 = 1$ pound. What is the equilibrium exchange rate of the dollar? _____ Suppose that Britain purchases U.S. goods whose value is \$2.5 million. This implies a British demand for dollars of _____ and a British supply of _____.
- j. Return to the original equilibrium exchange rate; that is, $\$.50 = 1$ pound. If the exchange rate is pegged artificially high at $\$1 = 1$ pound, what situation would be likely to prevail in the current account of the U.S. balance of payments? _____ Why? _____
-

Problem 2

Complete this table to obtain all the possible exchange rates between the six different currencies listed. The first row tells how much foreign currency one U.S. dollar can purchase.

	Dollar	Deutsche Mark	Pound	Franc	Yen
Dollar	1	2	1/2	6	120
Deutsche Mark					
Pound					
Franc					
Yen					

Problem 3

Use this table, which shows the balance of payments for the country of Atlantis, to answer the following questions

	Receipts	Payments	Balance
Current Account			
Merchandise Exports	+220		
Merchandise Imports		-328	
Trade Balance			
Net Investment Income			
Net Services		-1	
Net Unilateral Transfers		-11	
Current Account Balance			-102
Capital Account			
Capital Outflows			
Capital Inflows	+93		
Statistical Discrepancy	+36		
Official Reserve Transactions Balance			+6
Method of Financing			
Increase in Atlantis Official Reserve Assets		-9	
Increase in Foreign Official Assets			
Total Financing of Surplus			-6

- Fill in the missing entries.
- The trade balance is equal to _____. This indicates a trade (surplus/deficit).
- The final balance (after financing) equals _____. Is this is coincidence? _____
- The statistical discrepancy accounts for what kinds of transactions? _____

ANSWERS

Matching		True/False		Multiple Choice		Unlimited MC
Set I	Set II					
1. h	1. a	1. F	11. T	1. e	11. b	1. bc
2. g	2. j	2. T	12. T	2. b	12. e	2. bcd
3. b	3. f	3. T	13. T	3. b	13. e	3. bd
4. i	4. h	4. T	14. F	4. a	14. b	4. abc
5. c	5. i	5. F	15. F	5. b	15. a	5. bc
6. a	6. b	6. F	16. T	6. a	16. e	
7. j	7. g	7. F	17. F	7. b	17. c	
8. f	8. d	8. T	18. F	8. b	18. a	
9. e	9. c	9. T	19. F	9. c	19. d	
10. d	10. e	10. T	20. T	10. a	20. e	

Chapter Review (Fill-In Questions)

1. nominal exchange rate; balance of trade; balance of payments; foreign exchange
2. fixed; gold; foreign exchange; exchange
3. flexible; importer's; exporter; exporter; exchange risk; forward
4. deficits; key; precautionary; asset; seignorage; production costs

Problem 1

- a. .50 pound
- b. \$2
- c. .50 pound
- d. \$2
- e. law of demand
- f. law of supply
- g. 1 million; 2 million
- h. demand for dollars increases and the supply of pounds increases; depreciates; appreciates; increases; decreases.
- i. 1 pound; \$2.5 million; 2.5 million pounds
- j. deficit; surplus of dollars due to exchange rate imbalance.

Problem 2

	Dollar	Deutsche Mark	Pound	Franc	Yen
Dollar	1	2	1/2	6	120
Deutsche Mark	1/2	1	1/4	3	60
Pound	2	4	1	12	240
Franc	1/6	1/3	1/12	1	20
Yen	1/120	1/60	1/240	1/20	1

Problem 3

	Receipts	Payments	Balance
Current Account			
Merchandise Exports	+220		
Merchandise Imports		-328	
Trade Balance			-108
Net Investment Income	18		
Net Services		-1	
Net Unilateral Transfers		-11	
Current Account Balance			-102
Capital Account			
Capital Outflows		-21	
Capital Inflows	+93		
Statistical Discrepancy	+36		
Official Reserve Transactions Balance			+6
Method of Financing			
Increase in Atlantis Official Reserve Assets		-9	
Increase in Foreign Official Assets	3		
Total Financing of Surplus			-6

- a. See table.
- b. -108; deficit
- c. 0; no
- d. Illegal transactions, tourist purchases, and foreign purchases of domestic securities.