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by Ayse Y. Evrensel, PhD

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Dedication

I dedicate this book to Myles Wallace, my teacher and dear friend.

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Introduction

I understand when people are perplexed about international finance. Been there, done that. But being perplexed about something can be good motivation to understand it. As a noneconomist (and a much younger person), I had the privilege of experiencing life in different countries such as Turkey, Brazil, and Switzerland, which greatly affected my career choice later.

Throughout the 1970s, the 1980s, and partly the 1990s, Turkey and Brazil experienced political struggles and economic problems. You could feel it in the streets, and bad news was everywhere in the media. Hyperinflation — annual inflation rates reaching 100 percent in Turkey during the early 1980s and several hundred percent in Brazil until the mid-1990s — was simply stunning. At the same time, these countries' currencies were depreciating. I sort of understood that part because I experienced it in my everyday life. I needed more of these countries' currencies to buy one unit of a hard currency such as the dollar, the German mark, or the Swiss franc.

By the way, although I didn't understand what was going on at that time, both official and unofficial (black market) places existed for buying or selling hard currency. Now I would call it *foreign exchange restrictions*, but then, it was just reality. Needless to say, when you sell your hard currency unofficially, you receive a lot more domestic currency than the official place gives you. Also, the International Monetary Fund (IMF) was part of these countries' daily life then. I understood that, for some reason, the central banks of these countries were losing hard currency. Sometimes they had problems paying imports. The IMF representatives visited these countries and worked out an austerity program in exchange for a large amount of hard currency. Then all newspapers published articles against the IMF and how awful the proposed austerity program was. People held demonstrations in the streets, shouting, "IMF, go home!"

Switzerland was a whole other experience. My experience in this country didn't include any of the previous stories about Turkey and Brazil. I could tell that Switzerland was a very expensive but low-inflation country. Its currency was holding its own against other currencies. I didn't experience any difficulty with exchanging currency there. In Switzerland, no restrictions governed exchanging foreign currency, so no black market in foreign currency existed. I didn't hear anything about a large deficit of any kind. Certainly, the IMF wasn't a part of everyday life there.

I had to learn international finance in a systematic way to understand my experiences when I was younger. This book reflects the same systematic way, which hopefully will help you understand international finance.

About This Book

A variety of people are the primary readers of this book. A student of economics can use it to supplement lectures and the textbook. A practicing economist may want to brush up on existing knowledge of international finance. Maybe learning more about exchange rates has been on your mind for awhile, and now that you have more time, you want to give it a shot. This book provides the fundamental knowledge necessary for people of all backgrounds to understand international finance. It contains the nuts and bolts of the subject, without going into great detail.

No matter who you are, your goal should be to *understand* the subjects of international finance. I've been a teacher for almost three decades. Sure, I can pose problems such as, "Suppose the demand–supply model of exchange rate determination, and graph the market for euros; show the effects of a higher inflation rate in the U.S. on the exchange rate." But I value the comments of my students on a news article much more as an assessment tool than their answers to exam questions. A news article has a lot of information, and sifting through information and using the relevant information to predict the change in the exchange rate is an accomplishment. Similarly, you may be part of conversations about China revaluing its currency or the gold standard being a much better system than the current one. When people talk, they say a lot of things, some that are relevant and some that aren't. Distinguishing between them and giving a straightforward and correct answer isn't easy at first. But practice makes perfect. Therefore, I recommend that you put your knowledge to the test by reading exchange rates–related news and getting into conversations with others.

Another challenge in economic analysis is that this discipline offers alternative theories that explain the same subject. Therefore, this book offers two alternative theories of exchange rate determination, to help you compare the predictions of different models.

The best way to deal with model- and calculation-related challenges is to work with paper and pencil. Reproducing the models and calculations helps you make them your own.

Conventions Used in This Book

Italics emphasize an important point. In the previous section, I put *understanding* in italics because I wanted to emphasize gaining a fundamental knowledge, not just acquiring short-term knowledge that you lose the next day.

Bold is used when new terminology is presented.

- ✓ Bullet points such as this one indicate several points related to a certain subject. This convention makes it easy to visually separate different aspects of the same conversation.

What You Are Not to Read

I'm not sure whether I should say *unfortunately*, but you can't skip many parts of this book. I've included only a few "technical stuff" items and sidebars — you can skip those parts, if you want. Even though I've kept the details to a minimum, the nuts and bolts of the subject require quite a bit of analysis.

Foolish Assumptions

On the first day of all my courses, I distribute a couple subject-related questions among my students. I assure them that this isn't an exam and tell them to give me their honest opinion. At the second class meeting, I summarize their responses and post them on our class Blackboard site. Going over their answers sparks interesting conversations.

Based on the answers in my upper-level undergraduate international finance course, I can say that some students can do currency conversions and, looking at a time-series graph (say, with years on the x-axis and the dollar-euro exchange rate on the y-axis), can also tell when the dollar depreciated or appreciated against the euro. However, most of them cannot explain why the dollar depreciates or whether the world should return to the gold standard. The average reader of this book may be in the same situation as my students on the first day of the class. But most of my students eventually get a grasp of the subject, and it is my hope that you, the reader, will become equally (if not more) knowledgeable about international finance.

International finance is an area of economics — more precisely, macroeconomics. You may be aware of economics' approach to analyzing the subject based on models. Curves are shifting for whatever reason, and then you predict the changes in the variables on the x- and y-axis of the model. I hope that you don't think of it as boring. Remember my life experiences that I talked about at the beginning of this Introduction. These models were instrumental in making sense of my life experiences. If you don't already see this, I hope that you come to appreciate their power in explaining the world.

How This Book Is Organized

The parts of this book (Parts I through V) are its backbone. They are well defined in terms of their content. The sequence of these parts also is helpful for learning the material. Parts start with definition- and calculation-related subjects and progress over exchange rate determination and then later to the historical and current structure of the international monetary system. In terms of the content and sequence of chapters in each part, chapters correspond to the title of the part and are cohesive within each part.

In the following, you find information regarding the content of each of the five parts in this book, which helps you determine where you want to start in this book.

Part I: Getting Started with International Finance

Part I is about understanding the basics of exchange rates, such as definitions, conversion calculations, and the use of correct terminology when exchange rates change (see Chapter 2). In Chapter 3, I discuss the relevance of exchange rates for all sorts of international business. Even though this part doesn't give you the reasons for the changes in the exchange rates, it makes a visual start. Therefore, in Chapter 4, I show a couple graphs to illustrate how the relevant macroeconomic variables affect the changes in the exchange rate.

Part II: Determining the Exchange Rate

The chapters in Part II answer the question of why exchange rates change. This question is important to answer because Part I shows that all sorts of

international business and speculators are interested in predicting which way exchange rates will change. Part II introduces two models of exchange rate determination. First, the demand–supply model represents a basic approach to exchange rate determination (see Chapter 5). Second, it introduces the Monetary Approach to Balance of Payments (MBOP). Because the MBOP is a more extensive model, two chapters are devoted to it. Chapter 6 examines how to develop this model. Chapter 7 shows how you can use it to predict the change in the exchange rate.

Part III: Understanding Long-Term Concepts and Short-Term Risks

The first two chapters in Part III are related to the MBOP, which Part II examines. Among them are the concepts of interest rate parity (see Chapter 8) and purchasing power parity (see Chapter 9). These concepts relate the changes in the exchange rates to the interest rate and inflation rate differential, respectively. The last chapter in this section, Chapter 10, discusses foreign exchange derivatives such as forward, futures, and options contracts. Multinational firms use these financial instruments to hedge against exchange rate risk and investors use them to speculate.

Part IV: Conducting a Background Check: Currency Changes through the Years

Part IV is about exchange rate regimes and alternative international monetary systems. This subject requires discussing underlying macroeconomic subjects such as the connection between the type of money and the exchange rate regimes. Additionally, the chronological order in previous international monetary systems starts with the gold standard era of pre-1944 years (see Chapter 11). Chapter 12 examines the exchange rate regime and the associated problems during the Bretton Woods era (1944–1971), starting with the Bretton Woods Conference. Chapter 13 discusses diverse exchange rate regimes of the post-Bretton woods era, including floating and unilaterally pegged exchange rates, as well as currency crises. Finally, Part IV also examines the unique subject of the optimum currency area (OCA) and the challenges and opportunities associated with its materialization in the example of the euro (see Chapter 14).

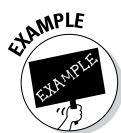
Part V: The Part of Tens

As in every subject, there are some things you should and should not be thinking about international finance. Chapter 15 summarizes some helpful points to consider. Chapter 16 points out some misleading considerations.

Appendix

To round out the book, famous puzzles in international macroeconomics and international finance put into perspective the exchange rate determination discussed throughout the book.

Icons Used in This Book



To aid you in your reading, this book uses the following icons:

This icon is used for all kinds of examples, both numerical and conceptual, to help you better visualize the subject in question.



Whenever you need to remember something that was discussed earlier to understand the current subject, you see this icon.



Sometimes the subject matter of international finance gets a bit academic — it can't help itself. This icon helps you weed through these more technical concepts — read them if you want a deeper understanding of subjects; otherwise, just pass them by.



Sometimes thinking about a subject in a certain way is helpful in learning. This icon is used whenever a suggestion is made.



Some subjects or expressions are open to misunderstandings. When you see this icon, you can expect an explanation of why it's a mistake to think about the subject in a certain way.

Where to Go from Here

Starting with Part I and moving forward with successive parts gives you nice insight into international finance. Follow this approach if you want to gain control over the subject in a reasonable amount of time.

But if you want, you can focus on one part at a time. For example, if you're more interested in the fixed vs. flexible debate or how the euro works, start reading the chapters in Part IV. If you want to know what depreciates or appreciates a currency against other currencies, start reading the chapters in Part II. However you choose to tackle this subject, *International Finance For Dummies* helps you grasp the concepts and enjoy the journey.

Part I

Getting Started with International Finance

getting started
with

**International
Finance**



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In this part . . .

- ✓ I start you off with a look at how international finance touches so many aspects of daily lives around the world.
- ✓ I give you an introduction to the most important subject in international finance: the exchange rate. I share some very handy basic information on exchange rate lingo and calculations.
- ✓ You get to meet the users of the foreign exchange market and understand what risks they face.
- ✓ I introduce a visual approach to changes in exchange rates.