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Chapter no. 5: International financial system: International finance and international financial institutions

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Financial system X International financial system

- A financial system is the system that covers financial transactions and the exchange of money between investors, lender and borrowers

- An international financial system means the same, but it involves investors, lenders and borrowers from different countries/states

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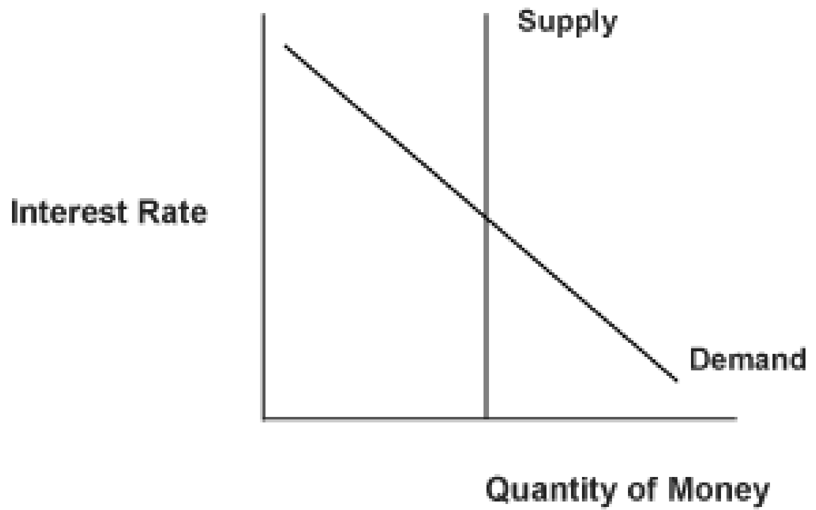
Foreign exchange rate

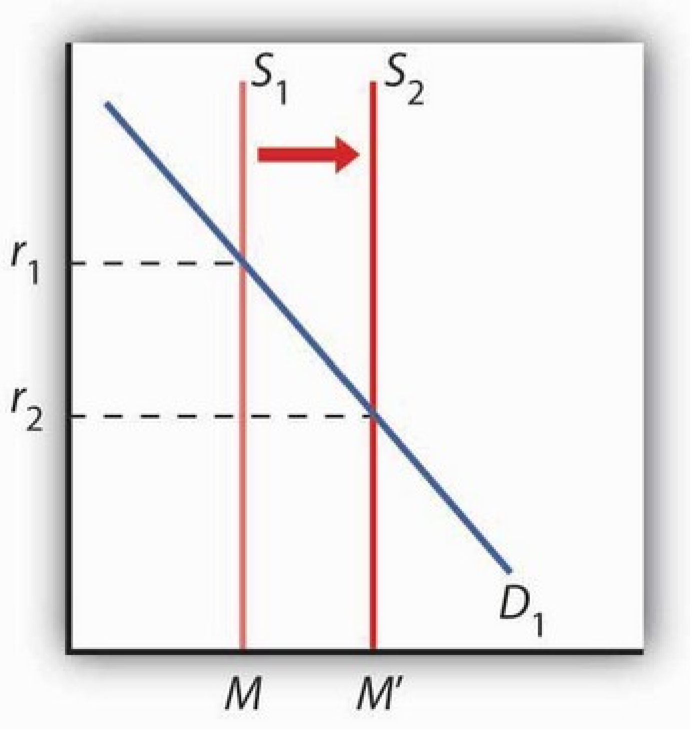
- Direct Quote
  - a foreign exchange rate quoted as the domestic currency per unit of the foreign currency
  - Example: 27 CZK / 1€

- Indirect Quote
  - A foreign currecny per unit of the domestic currency
  - 0.037 € / 1 CZK

Money supply, money demand and the equilibrium



Change in money supply



M… quantity of money
S…. money supply
D… demand for money
r…. interest rate

How can money supply be changed?

- Increase in money supply
  - In the way of printing money (which is pumped into the financial system)

- Decrease in money supply
  - Probably more complicated (Central bank cannot come to citizens and ask them for their money…)
  - Indirect withdrawal of money – how can this be done?
  - Increase in state bonds interest rate?

Inflation, deflation and hyperinflation

- Inflation
  - refers to prices rising over time, either in a particular industry or throughout the entire economy
  - Even healthy economics will always have some fluctuations, therefore, the inflation is not an unpleasant situation/state
- Hyperinflation
  - Unnatural situation (the value of a currency faces a sharp free fall)
  - Appears when a country‘s government prints more and more money
- Deflation
  - Negative inflation

Purchasing Power Parity (PPP)

- = an economic theory that compares different countries' currencies through a market "basket of goods" approach

- According to this concept, two currencies are in equilibrium or at par when a market basket of goods (taking into account the exchange rate) is priced the same in both countries.

- Such situation is not likely to work perfectly.

Purchasing Power Parity (PPP)

- The relative version of PPP is calculated as:
  - S = P1/P2

- Where:
  "S" represents exchange rate of currency 1 to currency 2
  "P_1" represents the cost of good "x" in currency 1
  "P_2" represents the cost of good "x" in currency 2

An example of PPP

- Let‘s suppose a pair of shoes costs 1,200 CZK in the Czech Republic. The same pair of shoes costs 40€ in Germany. If we take into account the up-to-date exchange rate of CZK and €, it might be concluded that this pair of shoes is more expensive in the Czech Republic (27CZK*40€=1,080CZK). If the PPP worked, the exchange rate of these two currencies would have to be:

S=P1/P2

S=1,200/40

S=30

Why PPP is unlikely to work?

- Transport costs
  - Even if two products/services have the same real value/price, costs of transport might eventually affect this equation

- Government interventions
  - Some governments might (intentionally) influence prices, either of domestic or foreign production

- Limited possibilities to transport some types of goods or mainly services
  - How can you transport services provided by a barber?

- Inflation

The World Bank

- The goal of the World Bank is to reduce poverty
- Loans are provided to citizens of developing countries (towards those people who would be hardly granted a loan from a bank)
- Created at the end of World War II

Advantages and disadvantages of such microloans

- +
  - Help to support world economy and developing countries
  - Gives a chance those who are unlikely to prosper without such type of bailout/support
- -
  - More risky loans, higher probability of defaults
  - Difficult to assess client‘s creditworthiness

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Thank you for your attention

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