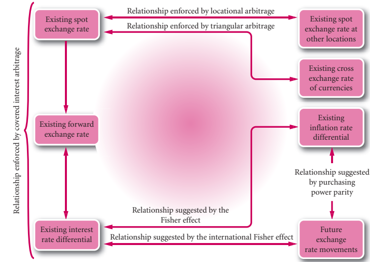
WALK THROUGH TOUR

PART II
EXCHANGE RATE BEHAVIOUR

PART 2 (Chapters 6–8) focuses on the critical factors that affect exchange rates. Chapter 6 explains how governments can influence exchange rate movements and how such movements can affect economic conditions. Chapter 7 explores further the relationship between currency value and interest rates. Chapter 8 discusses prominent theories about the links between inflation, exchange rates and interest rates.



Part opening diagram A diagram at the beginning of each part illustrates how the key concepts relate to one another.

CHAPTER 6
EXCHANGE RATE HISTORY AND THE ROLE OF GOVERNMENTS

LEARNING OBJECTIVES

The specific objectives of this chapter are to:

- describe the exchange rate systems used by various governments;
- oexplain how governments can use *direct* intervention to influence exchange rates;
- explain how governments can use *indirect* intervention to influence exchange rates;
- explain how government intervention in the foreign exchange market can affect economic conditions; and,
- outline the history of government and intergovernmental organizations in the management of exchange rates.

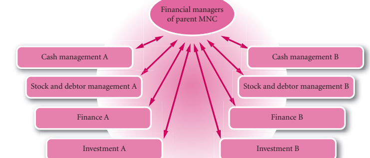
The previous chapters have begun to explore the relationship between the economy and the exchange rate. Governments use the exchange rate as an economic policy instrument to affect the economy. Such policies can be determined directly by the government or indirectly through membership of the European Union or G8. Financial managers need to be able to appreciate the relationship between governments, intergovernmental organizations and the exchange rate policy to understand the debate in the financial press and elsewhere on the likely development of exchange rates. Informed by such a debate, financial managers are then able to devise a policy on international finance relevant to their MNC. The complexities of exchange rate policy is illustrated by a brief history of notable events including the recent global financial crisis.

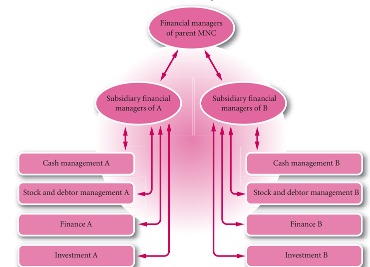
194

Objectives These define what you can expect to achieve as you read the chapter and what will be assessed by the exercises and other assessments as the chapter proceeds.

CHAPTER 1 MULTINATIONAL FINANCIAL MANAGEMENT: AN OVERVIEW 5

EXHIBIT 1.1 Financial management structures of MNCs





Exhibits These give a visual representation of key concepts or data.

CHAPTER 9 FORECASTING EXCHANGE RATES 321

of the forecasts. Some forecasting services focus on technical forecasting, while others focus on fundamental forecasting.

USING THE WEB

Exchange rate forecasts

A portal for foreign exchange predictions by a range of world banks can be found at: http://www.fxstreet.com/nou/continguts/forecasts.asp?publicitat1=cmesky the home site being http://www.fxstreet.com.

Forecasts are even provided for currencies that are not widely traded. Forecasting service firms provide forecasts on any currency for time horizons of interest to their clients, ranging from one day to ten years from now. In addition, some firms offer advice on international cash management, assessment of exposure to exchange rate risk, and hedging. Many of the firms provide their clients with forecasts and recommendations monthly, or even weekly, for an annual fee.

Performance of forecasting services

Given the recent volatility in foreign exchange markets, it is quite difficult to forecast currency values. One way for a corporation to determine whether a forecasting service is valuable is to compare the accuracy of its forecasts to that of publicly available and free forecasts. The forward rate serves as a benchmark for comparison here, since it is quoted in many newspapers and magazines.

Some studies have compared several forecasting services' forecasts for different currencies to the forward rate, and found that the forecasts provided by services are no better than using the forward rate. Such results are frustrating for the corporations that have paid substantial amounts for expert opinions.

Perhaps some corporate clients of these forecasting services believe the fee is justified even when the forecasting performance is poor, if other services (such as cash management) are included in the package. Alternatively, one may argue that the value of the services is not in necessarily being able to predict exchange rates on a day-to-day basis, but rather being able to anticipate high-risk situations and predict large changes in the exchange rate as with Black Wednesday 1992 in the UK, or the unpegging of the Argentine peso with the dollar in 2002 (see Chapter 6). It is also possible that a corporate treasurer, in recognition of the potential for error in forecasting exchange rates, may prefer to pay a forecasting service firm for its forecasts. Then the treasurer is not directly responsible for corporate problems that result from inaccurate currency forecasts. Not all MNCs hire forecasting service firms to do their forecasting, some may have in-house economists, others may hedge as a matter of policy.

EVALUATION OF FORECAST PERFORMANCE

An MNC that forecasts exchange rates must monitor its performance over time to determine whether the forecasting procedure is satisfactory. For this purpose, a measurement of the forecast error is required. There are various ways to compute forecast errors. One popular measurement will be discussed here and is defined as follows:

$$\text{Absolute forecast error as a percentage of the realized value} = \frac{|\text{Forecasted value} - \text{Realized value}|}{\text{Realized value}}$$

The error is computed using an absolute value because this avoids a possible offsetting effect when determining the mean forecast error. If the forecast error is 0.05 in the first period and −0.05 in the second

Using the web Identifies websites that provide useful information related to key concepts.

Summary Found at the end of each chapter, the summary offers a useful method of reviewing knowledge for exams by reminding students of what they have learned so far.

Critical debate A controversial topic is introduced, two opposing views are provided and students must decide which view they support and why.

Self tests A self test at the end of each chapter challenges the students on the key concepts. The answers are provided in Appendix A.

Questions and applications A variety of questions and other applications is designed to give students a thorough familiarity with the chapter material and to open up areas of further discovery.

BLADES PLC CASE STUDY

Consideration of foreign direct investment

Case studies Allow students to apply chapter concepts to a specific situation of an MNC.

SMALL BUSINESS DILEMMA

Developing a multinational sporting goods industry

Small business dilemma Students use the knowledge they have learned so far to make decisions about a small MNC.

Part 1 Integrative Problem

THE INTERNATIONAL FINANCIAL ENVIRONMENT

Integrative problem Found at the end of each part, this feature integrates the key concepts across chapters in that part.

Part 1 Essays/discussion and academic articles

Essays/discussion and academic articles At the end of each Part, a list of articles allows students access to the literature and get essay practice.