

Study Plan

Chapter 15

Learning Objectives

After studying this chapter you should be able to:

- Describe the difference between fixed and floating exchange rates, and interpret exchange rate quotes taken from the Web or financial newspapers;
- Explain how the four parity relationships in international finance tie together forward and spot exchange rates, interest rates, and inflation rates in different countries;
- List the types of risks that multinational corporations face when they conduct business in different countries and currencies; and
- Revise the *NPV* decision rule for capital budgeting analysis to incorporate the added complexity that arises when an investment is undertaken in a foreign currency.

Summary and Conclusions

- Though the major currencies of the world float freely against each other, many countries have adopted exchange rate policies that fix the value of their currency relative to the currencies of other nations.
- A currency appreciates when it buys more of another currency over time. A currency depreciates when it buys less of another currency over time.
- The spot exchange rate applies to immediate currency transactions, whereas the forward exchange rate applies to trades that take place at some future time.
- The foreign exchange market is the world's largest financial market and attracts many types of participants including exporters and importers, investors, hedgers, speculators, governments, and dealers.
- The four parity relationships in international finance spell out how spot and forward exchange rates are linked to inflation and interest rates in different countries.
- When firms conduct business in other countries and currencies, they face exposure to transactions risk, translation risk, economic risk, and political risk.
- When a firm analyzes a capital investment in a foreign currency, it can either discount the foreign currency cash flows using a foreign cost of capital, or it can calculate the domestic currency equivalent of those cash flows using forward rates and discount them at the domestic cost of capital.