

Due to growth in international business over the last 30 years, various international financial markets have been developed. Financial managers of MNCs must understand the various international financial markets that are available so that they can use those markets to facilitate their international business transactions.

FOREIGN EXCHANGE MARKET

The **foreign exchange market** allows for the exchange of one currency for another. Large commercial banks serve this market by holding inventories of each currency so that they can accommodate requests by individuals or MNCs. Individuals rely on the foreign exchange market when they travel to foreign countries. People from the United States exchange dollars for Mexican pesos when they visit Mexico, or euros when they visit Italy, or Japanese yen when they visit Japan. Some MNCs based in the United States exchange dollars for Mexican pesos when they purchase supplies in Mexico that are denominated in pesos, or euros when they purchase supplies from Italy that are denominated in euros. Other MNCs based in the United States receive Japanese yen when selling products to Japan and may wish to convert the yen to dollars.

For one currency to be exchanged for another currency, there needs to be an exchange rate that specifies the rate at which one currency can be exchanged for another. The exchange rate of the Mexican peso will determine how many dollars you need to stay in a hotel in Mexico City that charges 500 Mexican pesos per night. The exchange rate of the Mexican peso will also determine how many dollars an MNC will need to purchase supplies that are invoiced at 1 million pesos. The system for establishing exchange rates has changed over time, as described below.

History of Foreign Exchange

The system used for exchanging foreign currencies has evolved from the gold standard, to an agreement on fixed exchange rates, to a floating rate system.

Gold Standard From 1876 to 1913, exchange rates were dictated by the gold standard. Each currency was convertible into gold at a specified rate. Thus, the exchange rate between two currencies was determined by their relative convertibility rates per ounce of gold. Each country used gold to back its currency.

When World War I began in 1914, the gold standard was suspended. Some countries reverted to the gold standard in the 1920s but abandoned it as a result of a banking panic

in the United States and Europe during the Great Depression. In the 1930s, some countries attempted to peg their currency to the dollar or the British pound, but there were frequent revisions. As a result of the instability in the foreign exchange market and the severe restrictions on international transactions during this period, the volume of international trade declined.