

Overview of International Finance

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Key concepts, institutions, and mechanisms that shape cross-border financial activity.

1. Foundations

Element	Description
International Finance	Study of monetary interactions among countries: capital flows, exchange rates, and the global financial system.
Objectives	• Allocate capital efficiently across borders • Manage currency risk • Support international trade and investment • Stabilize economies through policy coordination
Core Questions	1. How are exchange rates determined? 2. What drives international capital flows? 3. How do governments and institutions influence global finance?

2. Exchange Rate Regimes

Regime	Main Features	Typical Examples
Fixed (Pegged)	Central bank commits to a set rate against another currency or basket; intervenes to maintain the peg.	Hong Kong dollar (USD peg), Saudi riyal (USD peg)
Floating (Flexible)	Rate determined by market forces; central bank may intervene occasionally.	US dollar, Euro, Japanese yen
Managed Float (Dirty Float)	Mostly market-driven but with occasional official interventions to smooth volatility.	Indian rupee, Brazilian real
Currency Board	Domestic currency fully backed by foreign reserves; strict conversion at a fixed rate.	Bulgaria (until 2020), Estonia (pre-Euro)
Dollarization / Euroization	Domestic economy adopts a foreign currency as legal tender.	Ecuador (USD), Montenegro (Euro)
Key Concepts		

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- **Nominal vs. Real Exchange Rate** – Real rate adjusts for price level differences.
- **Appreciation / Depreciation** – Direction of change in the value of the domestic currency.
- **Currency Crises** – Sudden, large devaluations often triggered by unsustainable pegs or capital flight.

3. Determination of Exchange Rates

Theory	Core Idea	Main Drivers
Purchasing Power Parity (PPP)	Identical goods should cost the same when expressed in a common currency.	Relative price levels, inflation differentials.
Interest Rate Parity (IRP)	Expected return on domestic assets equals return on foreign assets after accounting for exchange rate changes.	Interest rate differentials, forward/spot rates.
Mundell-Fleming Model	Extends IS-LM to open economies; shows interaction of monetary/fiscal policy with exchange rates under different capital mobility.	Policy stance, capital mobility, exchange rate regime.
Portfolio Balance Approach	Exchange rates reflect supply/demand for assets, not just money.	Asset preferences, risk premia, expectations.
Behavioural Models	Market participants' expectations and herd behaviour influence rates.	Sentiment, speculative flows, news.

4. International Capital Markets

Market	Instruments	Participants
Foreign Exchange (FX) Market	Spot, forward, swaps, options, futures	Banks, corporations, hedge funds, central banks
International Money Markets	Treasury bills, commercial paper, certificates of deposit	Sovereign borrowers, multinational corporations
International Bond Markets	Eurobonds, foreign currency bonds, sovereign bonds	Governments, supranational institutions, corporates
Equity Markets	ADRs/GDRs, cross-listed shares, global ETFs	Investors, issuers, index providers

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Market

Instruments

Participants

Derivatives Markets

Currency options, interest