Currency fluctuation: what causes it and how does it affect our economy essay exa...

[Economics](), [Currency]()

Currency fluctuation: What causes it and how does it affect our economy?

Introduction

Currency fluctuation refers to the continuing changes between the relative value of a currency issued by a particular country when compared with currency of another country (Heye, 2011). This process in fluctuation in currencies is a phenomenon that transpires every day and affects the relative rate of exchange on a repetitive basis. Currency investors look closely at these fluctuations in currency in attempt to generate profit from their investment. This paper looks at the causes of currency fluctuation, and its affects the economy. Currency fluctuations exhibit both downward and upward movements. When currencies purchased by an investor shows an upward movement relative to the currencies used to make the purchase, the investor stand a chance to benefit from the transaction. Similarly, if the exchange rate remains the same or the base currency increases in relative value, the investor may lose money or realize no return on the investment.

Causes of currency fluctuation

Exchange rate refers to the value of one currency relative to another currency. However, exchange rate fluctuates with time. There are political, financial, social, and economic factors that determine value of currency relative to another. Political factors have the potential of causing currency fluctuation (Rashed, Kuzmanovski, Dolfi, & Campo, 2010). For example, if a decision made in the country creates alarm among U. S. investors, it effects would likely spread to foreign investors. For example, electing a new president that inspires confidence may make markets for currencies and stocks rise. Similarly, an unexpected political shift or announcement with indefinite outcome can deter investors from purchasing U. S. dollars, as well as goods and services. However, in case of a more alarming report from another country, the dollar may gain relative to the currency of that country. Economic shifts also have the potential of causing currency fluctuation. For example, the 2008 global recession that forced the U. S. economy to collapse made the dollar fall to its lowest relative to the British pound. In addition, when the interest rate in home country is higher compares to other country, more foreign investors will be more attracted to invest in home county to maximize on capital gain. Such case can cause currency for the home country to increase and may make it to appreciate relative to the other country. Another cause of currency fluctuation is surplus or deficit in balance of payment. Surplus is a condition where the balance of payment for a country is higher than import. Normally, the currency value of a country with surplus increases compared to a country with a deficit. In other terms, when a country has more exports than imports, more importers will sell more foreign currency than exporters, which increases the demand for home currency thereby resulting into appreciation of currency.

Inflation and deflation also affect currency fluctuation. Inflation refers to the persistent increase in average price level of goods and services in an economy (Kandil, 2008). Inflation results into negative economic consequences including increase interest rates, loss of purchasing power, labor unrest, high uncertainty, and lower competitiveness. Higher inflation rate results into a more unstable economy. Deflation on the other hand refers to persistent fall in prices, but unlike inflation, deflation does not necessarily carry negative consequences. Typically, currency fluctuation results from macro-economic policies that policy makers put in place to check the effects of inflation and deflation. Depending on the applied policy, the demand and supply of currency will decrease or increase, consequently resulting into currency fluctuation.

In response to inflation, governments put in place policies that cause currency inflation. Increasing interest rates may result into high returns for traders and speculators. This consequently increases investment to the country and increase demand for the currency of the country. Flow of money into the country will result into upward movement in the value of the country's currency. Conversely, the central bank may decide to inject more money into the economy to boost demand. However, this increase in supply of money can result into inflation, thereby abating the value of the currency. This will result into downward movement in the value of the country's currency. Similarly, government may decide to increase taxes and decrease government spending. Increasing taxes will result into less disposable income as well as aggregate demand. Additionally, reducing government spending will make many people lose jobs, consequently reducing their ability to pay for goods and services. Such policies can result into massive unemployment resulting into downward movement in the currency of the country.

How currency fluctuation affect our economy

The U. S. economy has had a flexible exchange rate that has served as a buffer from external shocks since the tragedy of September 11. In addition, the currency fluctuated significantly at the height of the recent global recession, which hit the U. S. most. Consequently, the exchange rate experienced an upward movement as commodity prices recovered thereby making the U. S. economy fare relative to other countries. Fluctuation in exchange rate has a significant impact on the overall economy of a country. If the U. S. dollar appreciates relative to Chinese yen, this indicates that the U. S. economy if strengthening with respect to Chinese economy. Upward movement in exchange rate of a currency relative to another has positive impacts to an economy. Appreciation of currency results into increased direct foreign investment, which strengthens national economy by supporting industries such as textile leading to high employment.

Changes in exchange rates can have significant in international trade. Foreign investors will eventually earn profits when the value of U. S. dollars appreciates and make a loss if depreciates. Generally, appreciation of a country’s currency makes imports cheaper and exports expensive. This can benefit for companies who rely on import of heavy goods such as heavy machinery, microchip, and technology. This is so because they will only pay less for the imported raw material, which would boost their profit margin. Correspondingly, depreciation in U. S. currency makes imports expensive and exports cheaper. This will generate advantage for textile, IT, and tourism industry, which generate majority of revenue from exporting their goods and services. Similarly, a tourist would come to the U. S. thus increasing business of these sectors.

Conclusion

In conclusion, national currencies move in relation one another. These changes have implications on the exchange rate and affect economic development of a country. Currency investors depend on these fluctuations in order to generate profit from their investment. From this paper, it is evident that the causes of currency fluctuation include political, social, financial, and economic factors. In addition, currency fluctuations have negative and positive implication of the economy of a country as it may serve to buffer or befit a country. Government policies always come in place to check the negative impacts of currency fluctuations.

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