Factors that influence the exchange rate economics essay

The exchange rate is the rate at which one currency trades against another on the foreign exchange market. The exchange rate reflects the position of the national economy in the background of the world economy. The level of exchange rate represents an element of credibility of the national monetary system. It is considered as an important macroeconomic factor as a part of the monetary policy. Moreover, the recent Asian currency crisis represents how critically exchange rates impacts economic developments. The key factor leading to the crisis was the maintenance of pegged exchange rate regimes which encouraged external borrowing and resulted in excessive foreign exchange risk exposure.

This report will look into the different factors that influence the exchange rate and its impact on economy by making a relative comparison between US and UK and also highlighted some benefits of having weak currency.

Factors that influence exchange rate

Inflation:

Changes in relative inflation rates can affect international trade activity, which affects the demand and supply of currencies and thus influences exchange rates. For example, if US inflation rate increases and UK inflation rate remain the same, the British exports then tend to be more competitive which led to increased demand for British goods and hence US demand for UK currency increases.

In addition, the jump in the US inflation should reduce the British demand for US goods and therefore reduce the supply of pounds for sale. The US demand for pounds and reduced supply of pounds for sale will put an upward pressure on the value of pounds.

Interest rates:

Changes in relative interest rates influences the investment in foreign securities, which influences the demand for and supply of currencies and therefore influences exchange rates. For example if US interest rate rises and British interest rate remained same. In this case, demands for British pounds will likely to be reduced, since US rates are more attractive to the investors and there will be less desire for British bank deposits. Supply of pounds for sale by the British investors should increase as they establish more banks deposits in the United States. This can be seen as an inward shift in the demand for pounds and an outward shift in the supply of pounds for sale and hence the exchange rate should decrease. Sometimes, change in the interest rate to the third country can also affect the exchange rate between the two countries. Suppose if Canadian interest rates increases, it becomes more attractive to the British investors than the US rate. The supply of pounds to be exchanged for dollars will be smaller which places an upward pressure on the value of pounds against the US dollar.

However, it is very important to consider the real interest rate as relative high interest rate may reflect expectations of relatively high inflation which can place downward pressure on the local currency. So, real interest rate adjusts the nominal interest rate for inflation.

Real interest rate = nominal interest rate-inflation rate

Income levels:

Another factor affecting exchange rate is the relative income level. Income level of the country determines the imports demanded which affects the exchange rate.

If the US income level rises while the British level of income remains the same. The scenario will represents three situations: a) the demand schedule for pounds will shift outward reflecting the increase in US income and therefore increased demand for British goods, b) the supply schedule of pounds for sale is not expected to change, c) exchange rate of pounds will rise.

Balance of payments:

The balance of payments, the economic variable that influence the exchange rate; an increase in the level of deficits determines the depreciation of the local currency while decrease will result in an appreciation. For example, current account deficit in US of 7% of GDP was one reason for depreciation of dollar in 2006-2007. Due to a fact that balance of payment includes current account and capital account, its influence on exchange rate is complex sometimes reversed, so if a trade deficit which generally led to the depreciation of currency can be covered by the capital inputs in such a way that it generates an appreciation on local currency.

Some other factors are:

Speculation:

Speculators make profit through the margin they seek in buying and selling of currencies. If speculators believe that pound will rise in near future, they will demand more now to be able to make more profit. This increase in demand will cause the value to rise. Movement in the exchange rate is not always directed by the economic fundamentals, but driven by sentiments of financial markets.

Change in competitiveness

To increase the long run value of the currency, it is necessary to increase the competitiveness in the global markets. For example, if British goods become more attractive and competitive this will also cause the value of exchange rate to rise.

Relative strength of other currencies is another factor that determines the exchange rate and has a vice-versa effect. For example, between 1999 and 2001, the pound appreciated because the euro was seen as a weak currency.

Merits of weak currency:

Weak currency also provides plenty of opportunities

Increased exports:

One of the biggest reasons why weak currency helps the economy is because it increases the competitiveness of country's goods. It boosts the foreign demand while keeping the local consumers demand domestic. These benefits of sale will translate into more jobs and consumer spending and also reduce the trade deficit of the country.

Foreign investment:

Foreign investment can support the country’s economy and weak currency in different ways, if the currency continues to fall; foreign investor may begin to load up on companies with sound fundamentals that are also less vulnerable to economic slowdown. A weaker currency will also makes the corporations more attractive buyout targets. Sovereign wealth funds of many countries like china and Dubai are flush with cash and are on the lookout for goods investment opportunities.

Increased tourism:

Tourism is considered as major source of revenue for many countries and also generates employment in the country. Weak currency attracts more tourism as they offer more savings on their expenditure. For example, a USD $250 hotel room cost CAD $295, now it only cost CAD $250 which represents 15% of savings.

Conclusion:

This report has explained the series of factors that influences the exchange rate starting with imports and export, interest rate, inflation rate and balance of payment which are considered as the main determinant of exchange rate. These key economic factors can influence exchange rate movements through their effects on demand and supply conditions. These factors cause change in international trade or financial flows, they affect the demand for a currency or supply of currency for sale and therefore affect the equilibrium exchange rate. Then, the report moved towards merits of weak currency which explored the opportunities like increased employment, more consumer spending, foreign investment and tourism which directly contributes towards the country's economy even at the time of diminishing value of its local currency.