

Determinants for the exchange rates in long run



**ASSIGN
BUSTER**

Table of Contents (Jump to)

1. Introduction

2. Determinants can affect the foreign exchange value of a currency in a long term

2. 1. Purchasing power parity (PPP) and inflation rates

2. 2. Growth rate of the economy

2. 3. Interest rates

2. 4. Commodity prices

2. 5. Foreign direct investment and international speculation

2. 6. Exchange rate expectations

2. 7. Intervention into the foreign exchange market from authorities

3. Conclusion

Reference list

1. Introduction

The foreign exchange market is primarily a wholesale market, where transactions are of the order of hundreds of thousands of dollars or even greater. The marketplace can consist of a telecommunication network and a range of information technology system, which help provide a mechanism for the exchange of currency around the world. The retail market where small volumes can be handled is often at a shop front location, such as an

<https://assignbuster.com/determinants-for-the-exchange-rates-in-long-run/>

exchange bureau, a bank. In fact, the currency exchange rate is not only impacted by the law of demand and supply but also other determinants.

The paper identifies and evaluates many determinants for the exchange rates in long run. These determinants are (1) purchasing power parity and inflation rates, (2) growth rates of the economy, (3) interest rates, (4) commodity prices, (5) foreign direct investment and international speculation, (6) exchange rates expectations, and (7) intervention into the foreign exchange market from authorities. The relative impact of structural shocks on the movement of exchange rates after the Bretton Woods period has examined multivariate processes.

2. Determinants can affect the foreign exchange value of a currency in a long term

2. 1. Purchasing power parity (PPP) and inflation rates

If a domestic economy has higher inflation than the rest of the world, a decrease in demand for exports will result in the local currency exchange rates, which become less competitive in world market. Accordingly, there will be less demand for the local currency. On the other hand, when an increase in demand for imports as overseas goods become cheaper, compared to the domestic market, there will be an increase in supply of the local currency exchange rate.

The PPP theory is based on traded goods and services. The determination of the exchange rates has sustained the maintenance of purchasing power parity between currencies. ' PPP is indeed an important determinant of nominal currency valuation. ' The law of one price' asserts that, absent

impediments to free trade, goods and services should have the same relative price regardless of the country in which they are sold.' [1]

Which goods and services are cheaper in one country than another will be brought where they are cheap, and then to be sold where they are more expensive. From the viewpoint of exchange rate determination, PPP is useful as a reminder that the monetary policy has no long-run influence on the exchange rate. ' When PPP diverges more than 15-20 per cent from its historical mean, that has proven to be among the most accurate indicators of a pending change in currency trends,' [2] observed Mr. Eric Lonergan, global strategist for Cazenove in London.

Nevertheless, the exchange rate can stray away from its PPP. In fact, PPP exchange rates are determined by comparing the national prices for a large volume of goods and services. A weaker PPP has contented in inflation rate, rather than actual prices of goods.

The fall in the value of domestic currency results in reducing local currency rate, compared to the rest of the world. This phenomenon can offset the pricing impact of inflation. As a result, nations with different inflation rates can expect their exchange rate to adjust to offset these differentials in long run. ' Real exchange rate movements do not completely coincide with perceived changes in competitiveness, reflecting a basic flaw in the PPP approach. Instead, the likely effects of exchange rate changes on the trade balance are often difficult to predict without further information regarding the source of the shock.' [3]

The theory seems to equalize interdependence between the exchange rate and inflation rates. It seems impossible to have inflation, if the domestic market value of the currency exchange is increasing. On the other hand, it is also impossible to avoid inflation if the market value of the currency is decreasing.

2. 2. Growth rate of the economy

If a nation experiences higher economic growth rate than its major trading partners, the income and demand for import-export goods and services will grow at a faster rate. As a result, paying for the growth of imports will consequently result in an increase in the supply of the local currency in the foreign exchange world. ' Productivity differences were found to have a negative and statistically significant effect both in the short-run and the long-run. This suggests that if the US becomes more productive relative to its major trading partners, incomes and imports rise, causing depreciation of the US dollar.' [4]

' In particular, structural components in both the current and capital accounts — underlying each country's net trade and net foreign asset positions — are shown to influence the path of the long-run real exchange rate for each country.' [5] The supply impact is to reduce the price of the local currency exchange while the demand impact is to increase the price of local currency. The net impact will depend on the strength of each separate cause.

2. 3. Interest rates

Fiscal considerations become fundamental determinants of the decision of different foreign exchange regime. ' In the long run, in contrast, exchange rate movements are driven by the " fundamental," leading to a relationship between interest rates and exchange rates that are more consistent with UIP [Uncovered interest parity]' [6] . What has happened in foreign exchange market might not accord with what happens a country where experiences higher interest rate and a fall in the value of its currency. If interest rates are constant, a country which has higher interest rate will result in higher inflation. Higher inflation will cause a depreciating currency.

The relationship between the impact of distinguishing interest rate movements on exchange rates can provide different impacts in terms of local currency exchange rate experiencing higher interest rates than the rest of the world. In fact, higher interest rates will encourage capital inflow to the domestic economy and discourage capital outflow. This phenomenon will result from overseas investors who have tried to place funds in domestic market in order to take advantage of higher returns. As a result, a domestic buyer can invest in a greater proportion of funds in domestic financial markets.

2. 4. Commodity prices

If export from a nation becomes more expensive due to inflation, overseas importers will turn to other nations. As a result, the value of the exporting nation will fall, together demand for and the value of the domestic currency.

On the other hand, if particular goods and services in a nation become more expensive because of the growth in commodity prices, the importers cannot

<https://assignbuster.com/determinants-for-the-exchange-rates-in-long-run/>

choose other suppliers since commodity prices are a worldwide incident. As a result, the importers will continue to import commodities from that nation.

The total value of the exports will go together with the demand for the domestic currency. The value of domestic currency will increase.

The relationship between the trade balance and the exchange rate might not reveal the whole picture of the impacts of real depreciation on the trade balance and import-export flows. ' There exists a significant long-run relationship between the-dependent variables and their determinants in most cases. A real depreciation of US dollar will decrease US imports and increase US trade balance overall in the long run.' [7] The import-export trading functions have shown that currency depreciation has different impacts on imported-exported goods; the authority should take into consideration in a nation's trade policy.

2. 5. Foreign direct investment and international speculation

Foreign direct investment and international speculation can drive the domestic economy changes. Capital inflows to strong economies and outflows from weaker economies depend on how foreign investors speculate the perspectives of a domestic economy. Likewise, a recent decline in domestic currency as its economy becomes less attractive for investment compared to that of world's largest strong economy. ' Determinants of the equilibrium real exchange rate also include factors that affect the net trading position of the home country in world markets, as well as the underlying propensity of the home country to be a net lender or borrower of capital. In other words, the interaction between the permanent structural components

in both the current and capital account jointly determine the sustainable real exchange rate.’ [8]

Globalization has increased the differential between growth of world trade volumes and growth of world GDP as well; thereby enhance import-export activities of a nation. ‘ The Brazilian real displays useful information about the long-run path of other currencies in the region. In terms of volatility dynamics, while most currencies display evidence of time-varying variance, the volatility movements in the foreign exchange market seems to be mainly country specific.’ [9]

Evidence of common elements in the foreign exchange markets becomes substantial applications. From a macroeconomic standpoint, the movements have been towards financial integration; from the investors’ standpoints, the implications have in term of the assessment of risk and hedging strategy development.

2. 6. Exchange rate expectations

One of primary impacts on exchange rate movement is the exchange rate expectations. Speculators have formed expectations about the future exchange rate movements and then will take action to fulfil the impact. If participants in foreign exchange market have expected the future value of domestic currency to reduce, they will sell domestic currency. This phenomenon will increase its supply in the foreign market which then causes a fall in its value. On the other hand, if participants speculate the value of

domestic currency to increase, they will buy domestic currency, increasing demand for that currency and bring about an appreciation.

‘ The exchange rate expectations are incorporated into a switching cost model via the method of exchange rate pass-through on product-specific and country-specific approach.’ ^[10] Foreign exchange traders shift the demand for a currency in expectation of making profits. These traders’ expectations might be wrong sometimes, and thus they might disturb the foreign exchange market ‘ unnecessary’. However, they have to speculate correctly on average; otherwise they would lose their money and close their business.

2. 7. Intervention into the foreign exchange market from authorities

Government or central bank can intervene into foreign exchange markets. They can exert a significant impact on the value of that country’s currency. Official intervention can happen through the activities of central bank, or directly regulate the foreign exchange market by rules, regulations or laws. For instance, the authority can choose a number non-bank authorized foreign exchange dealers. ‘ A disequilibrium in the money market significantly affects the level of the reserves in each country. The impact differs in magnitude from country to country depending on the degree of sterilization and the exchange rate regime.’ ^[11]

The central bank can intervene by establish to ‘ buy time’ for the participants in the currency market. ‘ If inflation is 10 per cent higher in Mexico than in the US, the peso would be expected to depreciate against the dollar by 10 per cent to maintain PPP. However, the success of central bankers in

controlling price inflation over the past decade has drastically cut inflation differentials between countries to the extent that PPP has only a minimal impact now on nominal exchange rates.' [12]

A government has been challenged by a time consistency phenomenon and commitment in technology that results from uncertainty and fixed cost. It will have to look for its choices to optimize the exchange rate arrangements by depending on past currency movement history for a given set of fiscal conditions. That is why with the same basis, some nations sometimes experience fixed or low inflation and other time confront the floating or high inflation in exchange rates.

3. Conclusion

Many determinants have impacts on the currency exchange in the long run. Sometimes, these determinants have mutually influenced on the currency exchange system. These determinants among the markets are pronounced in the long-term, where the short-term movements are usually in line with the long-term adjustments. The effects of these mentioned determinants are not uniform among nations. In fact underlying the movements in price, money and currency exchange rates are mutual and complex.

Reference list

Al-Salem, H., Ph. D. 2005, ' The demand for international foreign reserves of energy-exporting countries', Clark University, 222 pages; AAT 3163350

Chinn , DM & Meredith, G 2004, ' Monetary Policy and Long-Horizon Uncovered Interest Parity', *IMF Staff Papers*, Washington, vol. 51, no. 3, p. 409, viewed 12 May 2007

Faruquee, H 1995, ' Long-run determinants of the real exchange rate: A stock-flow perspective', *International Monetary Fund* Washington, vol. 42, no. 1, March, p. 80, viewed 12 May 2007

Huang , JC & Brahmaasrene, T 2003, ' The effect of exchange rate expectations on market share', *Managerial Finance*, Patrinton, vol. 29, no. 1, p. 55, viewed 12 May 2007

Ruiz, I. Ph. D. 2006, ' Essays on the Latin American foreign exchange market', Western Michigan University, 145 pages; AAT 3243164

Trygubenko, VO 2006, ' Effect of oil prices and other determinants on the United States dollar effective exchange rate', Southern Methodist University, 81 pages; AAT 1430298

Uhlfelder, E 2005, ' Riding the dollar roller coaster For eurozone investors, the weak US currency could provide an opportunity to profit from individual securities,' *Financial Times*, London (UK), 4 April, p. 5.

Wang, Yongqing , Ph. D. 2005, ' United States-China commodity trade and the Yuan/dollar real exchange rate', The University of Wisconsin – Milwaukee, 111 pages; AAT 3185620

Woolfolk, M. 2005, ' Why Dollars's trend has been downward', *Financial Times*. London (UK), 10 January p. 12, viewed 12 May 2007

[1] Woolfolk, M 2005, ' Why Dollars's trend has been downward', *Financial Times* . London (UK) 10 January, p. 12 viewed 12 May 2007

[2] Uhlfelder, E 2005, ' Riding the dollar roller coaster For eurozone investors, the weak US currency could provide an opportunity to profit from individual securities,' *Financial Times*, London (UK), 4 April, p. 5.

[3] Faruquee, H 1995, ' Long-run determinants of the real exchange rate: A stock-flow perspective', *International Monetary Fund* . Washington, vol. 42, no. 1. March, p. 80, viewed 12 May 2007

[4] Trygubenko, VO 2006, ' Effect of oil prices and other determinants on the United States dollar effective exchange rate', Southern Methodist University, 81 pages; AAT 1430298

[5] Faruquee 1995, p. 80

[6] Chinn , DM & Meredith, G 2004, ' Monetary Policy and Long-Horizon Uncovered Interest Parity', *IMF Staff Papers*, Washington, vol. 51, no. 3, p. 409, viewed 12 May 2007

[7] Wang, Yongqing , Ph. D. 2005, ' United States-China commodity trade and the Yuan/dollar real exchange rate', The University of Wisconsin – Milwaukee, 111 pages; AAT 3185620

[8] Faruquee1995, p. 80

<https://assignbuster.com/determinants-for-the-exchange-rates-in-long-run/>

[9] Ruiz, I. Ph. D. 2006, ' Essays on the Latin American foreign exchange market', Western Michigan University, 145 pages; AAT 3243164

[10] Huang , JC & Brahmasrene, T 2003, ' The effect of exchange rate expectations on market share', *Managerial Finance*, Patrington, vol. 29, no. 1, p. 55, viewed 12 May 2007

[11] Al-Salem, H., Ph. D. 2005, ' The demand for international foreign reserves of energy-exporting countries', Clark University, 222 pages; AAT 3163350

[12] Woolfolk, 2005