Effect of a rise in the exchange rate economics essay

“ We declare that this assignment is our own work entirely and suitable acknowledgement has been made for any sources of information used in preparing it.”

How the operations of international firms affected by the exchange rate system, the presence of capital controls and the segmented of capital markets? (30 marks)

The effect of a rise in the exchange rate on the supply of foreign exchange is ambiguous. Explain.

First of all, as we know that supply of foreign exchange is foreign currencies flow into the domestic economy which happens when foreigners import or buy goods and services from our country. For example, when the US dollars are valued high, foreign goods and services are cheaper to U. S buyer, so U. S consumer can buy more foreign goods and services and people will supply more dollars at a higher exchange rate.

Since a higher exchange rate means that a dollar can be traded for more other countries currency. Thus we can say that there is a positive relationship between the value of USD in terms of ringgit and the quantity of USD being supplied. The higher the value of USD in terms of ringgit, the more USD will be supplied. So, we can expect that the supply curve (s) for dollars to be upward sloping, as suggested in graph below. (The bond and foreign exchange markets)

The reason why we say that the effect of a rise in the exchange rate on the supply of foreign exchange is not clear is because demand and supply of foreign exchange will influences the determination of exchange rate, but the changes of the supply of foreign exchange are depending on the demand and not on the exchange rate. Even thought there are positive relationship between exchange rate and supply of foreign exchange rate. Thus, we can know that the changes in exchange rate might affect the supply of foreign exchange, but determinant of the changes of supply foreign exchange is not exchange rate.

Besides that, there are several factors that affect the changes in exchange rate and supply of foreign exchange. Firstly, the supply and demand of foreign exchange is depends on a lot of factors, such as Economic factors, Political factors and so on. Economic factors are include economic policies that formulated by central banks and government agencies, economic reports, conditions and others. For example, central banks include the Federal Reserve Bank of United States or the European Central Bank. Nowadays, banks are not only the participants within the foreign exchange market. There has been an increase in many non bank participants, such as individuals since the rise of high technology and the increasing accessibility of the market activity to ease. (CMSFOREX)

Furthermore, political conditions within and around the country also affect the currency market. Regional, central and international politics influence the currency market as well. Besides that, market psychology and the perception of the traders and buyers also affect the currency market in various ways. (Stanley St Labs) It is because the supply elasticity of foreign exchange refers to the responsiveness of sellers to movements in the rates.

Thus when the sellers are highly responsive to those changes, the supply can be said is elastic.

Moreover, for the industry that involved with indirect cost (land- intensive), its supply prices tend to rise when demand increases and to fall as demand decreases. But for the decreasing cost industries (capital intensive) the supply price will tend to decrease when the quantity demanded increase. It is because a decreasing cost industry occurs due to the entry of new firms, prompted by the increased demand, so that each form turned to long-term decline, thereby reducing the minimum efficient scale of production.

After we know the factors that determine the demand and supply of foreign exchange, we have to know the factors affecting foreign exchange rates as well, since they are related. There are 6 determinants of exchange rates which is inflation, interest rates, current account deficits, public debt, terms of trade, political stability and economic performance.

As we know that changes in relative inflation rate in a country can affect international trade activities in that country, such a change influences the demand and supply of foreign and home currencies and affect the foreign exchange rate also. Besides that, a country with a consistently higher inflation rate exhibits a depreciating currency value, as its purchasing power decrease relative to other currencies, thus this situation prompts people to buy foreign goods instead of buying domestic goods since it is much expensive than the goods from other countries. For example, Malaysia inflation rate increases suddenly, this would cause an increases in the Malaysia’s demand for foreign goods and then also cause an increase in the

Malaysia' demand for foreign currency. Thus there is negative relationship between inflation rate and exchange rate.

As a general rule, all investors would like to invest in country which interest rate is more attractive. It is because higher interest rates offer lenders in an economy a higher return relative to other countries. Therefore, higher interest rates attract foreign capital and cause the exchange rate to rise; it is because if Malaysia's interest rates are more attractive relative to US rates, US residents with excess cash would like to invest in Malaysia in order to get higher interest. In other words, more US dollars are converted to ringgit, results in an increase in supply of US dollars and ringgit will be appreciated.

Besides that, a deficit in the current account shows the country is spending more on foreign trade than it is earning which mean import more than export, and it suppliers more of its own currency than foreigners demand for its products. Thus, we can know that the excess demand for foreign currency will lowers the country's exchange rate until domestic goods and services are cheap enough for foreigners. Furthermore, public debt also will affect the exchange rate, since a large debt will encourage inflation and cause the inflation and then influence the exchange rate that discussed as above.
(Jason Van Bergen)

Since the terms of trade are related to current account and the balance of payments, thus it will affect the exchange rate also. Lastly, a country with positive attributes will draw investment funds away from other countries have more political and economic risk potentially.

As a conclusion, we can know that interest rates, inflation and exchange rates are highly correlated and the effect of a rise in exchange rate on the supply of foreign exchange is not clear since the supply of foreign exchange will not affected by the exchange rate even though there is positive relationship between them. Besides that, the changes in both are depending on several determinants.

Question 3:

How do tax policies and government regulations determine the pattern of foreign direct investment (FDI)? (30 marks)

During the 21st century, one of the keyword in the business field is globalization which business owners in the globalized economies are multinational corporations (MNCs) which can be approximated on the flows and amount of Foreign Direct Investment (FDI). FDI is a business relationship of a parent company and its foreign subsidiary which is a form of business that function outside of the domestic territory of the investors. In other word, FDI could be defined in an easier way as a company from one country making a physically investment at the other country by building a factory, outlet or stores at foreign country. In Malaysia, for non-resident investor, FDI is set up with the holding of at least 10% of the total equity in a resident company. Yet, Malaysia is one of the most successful examples of attracting high FDI in Southeast Asia by increasing country’s and company’s cash inflow. Malaysia government are updating the new strategies in order to attract more FDI to Malaysia and encouraging economy to foreign investors. (Trade Chakra, 2008). Apart from that, FDI is generally is economic development which would lead to job creation, therefore develop country are encouraging FDI to decrease unemployment rate.

MNCs are potentially subject to taxation in both parent and host countries; however most of the parent country could reduce or get rid of the thread of double taxation on their MNCs. In recent year, due to the increase number of MNC in the world which had led to an emergence of new issue. More companies tended to become more mobile therefore the domestic government tends to create a new dimension in designing a new national tax policy. The second issue is that, the recognition of tax policies of home and host countries are interconnected which could influence the behavior of multinationals. There has been a great dal of evidence shows that after the changes of U. S. tax laws during 1980s, the home country tax policy affects both countries on the multinational firm’s behavior and the effectiveness of tax policy in the countries on the firm that operate and invest. Tax policies are closely related in affecting the volume and location of FDI as all other considerations are equal. Tax policies was an important determinant for FDI and MNCs yet it wasn’t a primary determinant to the country as tax policy can still have some impact on FDI flows that heavily focus on tax policies. According to Altshules, Grubert and Newlon(2001), they found that there is adverse effects between corporate tax rates and some multinational activities. Corporate tax could declare firm’s profit in decision making on placing investment. As they estimate that the impact of tax policies has a significant impact on multinational investments and becomes stronger. According to the recent comprehensive studies of Mutti (2003), corporate tax brings an extreme impact on multinational’s decision making. For an instance, a 1% increase in corporate tax could lead cost of capital increase of 3% in their production. Countries with high corporate tax would experience a high net outflow of FSI and decline in corporate tax revenue which become an evidence in affecting corporate tax revenue have a sharp decline in the countries of Organization for Economic Cooperation and Development (OEGD). Although part of the decline would attribute to changes in tax codes and business-cycle, suggest that additional factors may word which is adjusting the size of FDI flows. The power of corporate tax policies would pursued by one country which can affect another countries in an different ways, for an instance, if domestic country's tax burden is higher than the other countries, the tax base may shift their FDI to a country which carries a less tax regime which implying the outward flows of FDI that can attract more inward investment flows as well. Domestic taxes should increase for outflows in exemption countries because firms can escape domestic taxation by investing abroad. Moreover, FDI outflows in credit countries should be less sensitive to taxes because they have no ways to escape domestic taxation. Yet the most common reasons that FDI affects corporate tax revenue are through the transfer pricing. For multinational country with high-tax country which producing goods from low-tax country, this inter-firm trade would overstate the price of their products because this could increase the profits in the low-tax country but reduce profit in high-tax country. Therefore as a conclusion on how tax policies could affecting the pattern of FDI brings a huge impact as tax policies could affecting a MNC in decision making that might eliminate and limited the profit making for companies which involved in FDI activities. (http://www. allbusiness.

com/accounting-reporting/corporate-taxes/794332-1. html)

Government regulation of foreign countries could be a barrier for company involved in FDI as different countries carries different regulation and pattern and closely increase a countries' current account balance. Government policies are designed to protect and assist both consumers and organizations. First, when the foreign Federal Government enacts the laws and regulations on their country, the government will assists specific organizations to implement with the laws and regulations with the financial resources provided. Therefore, it's important for parent company to conduct studies research on foreign government's regulation before they place their FDI to avoid unnecessary problems. In other words, domestic and international politics have tremendously differences between their government regulation of businesses due to different cultural and thinking. Therefore most of the companies that planned to place a FDI would prefer dealing with the national government in shaping business regulations rather than dealing with the international government because the policies and cultural are not clearly defined. Companies would need time to get used and understand the pattern of the living cultural environment and foreign government regulation which is time consuming. That's the reason that domestic company prefer to dealing with the national governments because of the trust and relationship that they have built with the domestic government in shaping the business environment and the differences between the cultural is smaller if compare with international. Business policies shaped by the national government are more familiar and clearly defined as opposed to regulations from the international governments.

(Osman Masahudu Gunu, 2009). The response of FDI to different tax rate level may may due to different across economic sectors.

FDI in natural resources could have a dramatic impact on the balance of payments and the tax revenues of the host country where the natural resources are found. Due to the exchange rate fluctuation, the taxes such as tariff charged by host countries' government could be a burden for MNC company. The tax rate would significantly high differences over the time between countries that affecting after-tax return to MNCs that involved in FDI, high taxes from government would restrict growth through FDI if human and capital resources are prevented from reallocation. Due to ample evidence, countries with lower tax rate could attract more FDI than countries that offering high tax rate as high taxes could deter FDI. FDI and economic growth is in a comprehensive manner which the volume and location of FDI is sensitive towards the tax treatment. It can be argued that countries may only benefit from foreign investment inflows if they have appropriate with local government regulations.

Government regulations such as restrict on employment law could brings a problem to the MNCs as it brings a lower labour market turnover and the cost of employing foreigners workers to work at local companies could be cheaper. A similar argument can be made for other forms of government regulations, such as protecting both foreign and domestic investors by ensuring creditor rights and enforcement of contracts. Both are difficult tasks involving high uncertainty, time consuming and high cost. Researchers examined that the impact of regulations across countries are heavily rely on few resources which include political risk. (Sabac , Florin M, 2010)

Political risk is referring to risk that political events and processes that happened in the host country which can closely affect the relationships between the host and home country. This brings enormous negative impacts towards the companies that placed their FDI in the particular countries. During the political risk, the taxes could increase dramatically and the alternatives for host governments to alter the cash flows from foreign operations in order to reduce cash flow due to higher taxes. Foreign governments will likely choose to do so only if the expected benefits of the expropriation or other cost to the multinational firm exceed the expected costs to the foreign government of these actions. The motivations of host countries to impose political costs have been on the effects of expropriation and reduce the number of companies that goes for FDI. Political tradition tends to influence the pattern of FDI because it influences the MNC’s investment decision making on placing FDI. For an instance, US state governments provided a grants training and labor skill development in their attempts to attract more MNCs interested to place their FDI at US. The way state government conducted the training is based on political tradition by confronting management are strong in Midwest, Northeast and other old industrial heartland. This shows that the political tradition has weaken the implementation of the existing state government investment by attracting more FDI. Consequently, although Midwest and Northeast have enormous number of major FDI projects buy they do not have a strong political tradition on confrontational their labor unions. Therefore, to attract more MNCs investment, government shouldn’t carry too much traditional thinking on developing the economics of the country. (Millward, 1999).

As a conclusion, the impact on the changes of tax policies and government regulations could heavily affecting the pattern of FDI. The restrictive of government regulations may prevent the productivity increase which related to the exploitation of technology by the FDI inflows. Tax policies and government regulation are closely related to each other