Assess the relationship between the balance of payments framework and exchange ra...

Finance

The Relationship between Balance of Payments and Exchange Rates The Relationship between Balance of Payments and Exchange Rates Balance of payments accounts record the transactions of a country with the other countries around the globe. Balance of payments compares the monetary disparity of the amount of imports and exports of a country. Exchange rate is the value of a currency relative to other currencies. Balance of payments comprises of the balances in the current and capital accounts. The relationship between exchange rate and balance of payments structure is that they correspond with one another. When an exchange rate of a country's currency reduces against currencies of other countries, the imports of that nation will decrease, and the exports will increase. For example, if there is U. S. dollar devaluation against other international currencies, then the United States exports will augment, and imports will reduce (Moffett, Stonehill & Eiteman, 2011).

In turn, this will lead to surplus in the current account, thus enhancing balance of payments. A higher exchange rate makes a nation's imports cheaper and exports more costly in international markets. A higher rate of exchange may be anticipated to lower balance of trade of a country, whereas a lower rate of exchange would augment it. There is a higher correlation between exchange rates, inflation and interest rates. In order to stimulate economic growth, monetary authorities change interest rates, thus affecting exchange rates and inflation. Higher rates of interest lure foreign investment and cause rate of exchange to increase. When there is a current account deficit, countries tend to increase the demand for foreign currency. Increase in demand of overseas currency lowers the exchange rate

(Connolly, 2006).

References

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Moffett, M., Stonehill, A. I. & Eiteman, D. K. (2011). Fundamentals of Multinational Finance. New York: Prentice Hall.