Economics: Impact of the Currency Exchange Rate on National Economy

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Outline

Impact of the Currency Exchange Rate on National Economy

Nowadays, business transactions become more and more complicated due to the interdependence between different economic segments. The currency exchange rate is one of the definers of the relationships and goods exchange in the international arena. The concepts of supply and demand and market equilibrium determine a value of a particular currency in international transactions while not only having a critical impact on economic relationships between international players and enabling trade but also affecting the overall condition of the national economy (Richards, 2015). Consequently, the primary goal of this essay prompt is to unveil the spheres of influence of the currency exchange rate and describe its effect on inflation, interest rates, trade, GDP, and Foreign Direct Investments (FDIs). In the end, conclusions are drawn to summarize the main findings of the paper.

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Inflation

In the first place, there is a strong correlation between inflation and the currency exchange rate. Inflation implies a rapid increase in prices for goods and services, and these changes reduce the purchasing power of the currency in the foreign exchange market while the currency exchange rate also defines the intensity of inflation (Richards, 2015). Thus, it is critical to describe this interdependence with the help of a historical example. In the recent past, fixed exchange rate limited the actions of countries and made them less flexible and responsive to various political, economic, and social events. According to the Jamaican Agreement, the major solution to this issue was introducing a mechanism of floating exchange rate that implied a dependence of the currency's value on the laws of supply and demand and the invisible hand of the market (Richards, 2015). Unfortunately, for the United States of America, it resulted in the depreciation of the US dollar and its constant decline in value in the foreign exchange market (FOREX). This instability triggered a gradual rise in inflation rates causing a continuous decline in aggregate demand and provided a well-developed rationale for the government to pay attention to this economic factor.

Interest Rates

It is evident that central banks of countries consider all the elements of the international economy including the currency exchange when developing a well-designed monetary policy and interest rates (Swift, 2016). Along with that, it assists central banks in managing foreign currency reserves and growth of the market (Swift, 2016). All these steps are critical since they help respond to economic changes promptly and avoid adverse consequences. Often, central banks use interest rates as a financial tool, as increasing them will limit the growth pace while decreasing them will support active lending and economic development (Swift, 2016). In this instance, a strong domestic currency will play a similar role since it will limit the actions of national producers due to its attractiveness to importers. It will intensify competition in the market and set high-quality standards and entry barriers for domestic manufacturers. Having a strong currency for an extended period may be destructive for the economy, and decreasing interest rates may become a requirement.

Trade

As it was depicted earlier, the currency exchange rate has a critical impact on international relations and trade. In the first place, the value of the currency itself presents the laws of supply and demand, as it is dependent on both curves and speculations in FOREX (Richards, 2015). Along with that, the values of different currencies enable transactions internationally. Having a strong or weak currency defines whether the country is more suitable for imports or exports. This approach helps understand potential profits to be acquired in the case of export or import activity. In this case, a country with a strong currency will be highly suitable for imports. For example, Switzerland with its high value faces economic instability and cannot rely on exports (Atkins, 2017). On the contrary, the weak currency will be beneficial for exports. A combination of these factors states that the value of the currency will define the actions of the companies in the market while high levels of import may result in the intensified rivalry and negatively affect the national economy.

Foreign Direct Investment (FDI)

Another vital aspect that is highly affected by the currency exchange rate is the investment inflow and outflow. In this case, one of the forms of funding is FDI, and it implies that a foreign investor offers financial resources to the company located in another country (Wren & Jones, 2012). On the one hand, it is beneficial, as it attracts more financial resources to the country and makes it more financially stable. On the other hand, international companies often use this instrument to expand their operations abroad (Wren & Jones, 2012). When referring to the currency exchange rate, it could be said that the countries with strong currencies are often discovered as the major sources of FDI. Thus, before making a particular investment in one of foreign companies, it is logical to conduct a sufficient environmental analysis and determine the business's viability and financial health in the current economic conditions. In this case, stable currency is also viewed as a definer for attracting FDIs, and China and India are the bright examples of economies with suitable features for foreign investors.

Economic Growth and GDP

In turn, the previous topics clearly imply that the currency exchange rate has a critical impact on profitability and economic growth. A low currency contributes to the economic development of the country while a strong one has an unfavorable impact on its development. A current condition in Switzerland depicted above can be discovered as one of the major examples that show this relationship. For example, the value of Swiss franc is high, and it limits its opportunities for export (Atkins, 2017). Along with that, the country becomes highly attractive for FDIs, and these transactions may continue supporting a rapid rise in the value of the currency. A combination of these factors explains the present economic recession faced by Switzerland, and the government should consider revising its monetary policy to mitigate the existent risks.

Conclusion

Overall, it could be said that an immense impact of the currency exchange rate cannot be underestimated since to some extent, it determines the curves of supply and demand, defines the company's position in the international arena, and can organize a transition from one economic cycle to another. Along with that, monitoring the currency exchange rates can be viewed as a favorable platform to control inflows and outflows of cash and attract FDIs, as these attributes can be regarded as key definers of the national growth. In the end, a combination of these factors provides a clear rationale for the fact that the government purposefully utilizes an array of mechanisms to modify the currency exchange rate in the desired way.

References

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