Factors that influence exchange rates

IT'S ALL ABOUT TRADING

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Exchange Rate is "the price of a nation's currency in terms of another currency"

AS AN ECONOMIC MEASURE

Exchange rates are one of the most watched and analysed economic measures across the world and are a key indicator of a country's economic health.

Rates are not just important to governments and large financial institutions. They also matter on a smaller scale, having an impact on the real returns of an investor's portfolio.

ECONOMIC INFLUENCES

Strong currencies make a nation's exports more expensive and imports from foreign markets cheaper, whereas weaker currencies make exports cheaper and imports more expensive. Higher exchange rates adversely affect a country's balance of trade but lower exchange rates have a positive effect on it.

Difference between base and counter currency

An exchange rate has a base currency and a counter currency. In a direct quotation, the foreign currency is the base currency and the domestic currency is the counter currency. In an indirect quotation, the domestic currency is the base currency and the foreign currency is the counter currency.

Most exchange rates use the US dollar as the base currency and other currencies as the counter currency. However, there are a few exceptions to this rule, such as the euro and Commonwealth currencies like the British pound, Australian dollar and New Zealand dollar.

Exchange rates for most major currencies are generally expressed to four places after the decimal, except for currency quotations involving the Japanese yen, which are quoted to two places after the decimal.

Furthermore, exchange rates can also be categorized as the spot rate – which is the current rate – or a forward rate, which is the spot rate adjusted for interest rate differentials.

Let´s consider some examples of exchange rates to enhance understanding of these concepts:

- **US$1 = C$1.1050**

Here the base currency is the US dollar and the counter currency is the Canadian dollar. In Canada, this exchange rate would comprise a direct quotation of the Canadian dollar.

This is easy to understand intuitively, since prices of goods and services in Canada are expressed in Canadian dollars; therefore the price of a US dollar in Canadian dollars is an example of a direct quotation for a Canadian resident.

- **C$1 = US$ 0.9050 = 90.50 US cents.**

Here, since the base currency is the Canadian dollar and the counter currency is the US dollar, this would be an indirect quotation of the Canadian dollar in Canada.

- **If US$1 = JPY 105, and US$1 = C$1.1050, it follows that C$1.1050 = JPY 105, or C$1 = JPY 95.02**

For an investor based in Europe, the Canadian dollar to yen exchange rate constitutes a cross currency rate, since neither currency is the domestic currency.

Flexible (or floating) Exchange Rates

Exchange rates can be floating or fixed. Most exchange rates are determined by the foreign exchange market, or forex. That's called a flexible exchange rate. For this reason, exchange rates fluctuate on a moment-bymoment basis.

The flexible rates follow what forex traders think the currency is worth. Those judgments depend on a lot of factors. The three most important are central bank's interest rates, the country's debt levels and the strength of its economy.

The United States allows its forex market to determine the U.S. dollar's value. The U.S. dollar strengthened against most currencies during the 2008 financial crisis. When stock markets fell worldwide, traders flocked to the relative safety of the dollar. But, why was the dollar safe? After all, the crisis started in the United States. Here's more on why the dollar is so strong right now. Despite this, most investors trusted that the U.S. Treasury would guarantee the safety of the world's global currency.

The dollar took on that role when it replaced the gold standard during the 1944 Bretton Woods agreement.

Fixed Exchange Rates

A fixed exchange rate is when a country's currency doesn't vary according to the forex market. The country makes sure that its value against the dollar, or other important currencies, remain the same. It buys and sells large quantities of its currency, and the other currency, to maintain that fixed value.

For example, China maintains a fixed rate. It pegs its currency (the yuan), to a targeted value against the dollar. As of June 19, 2017, one dollar was worth 6.806 Chinese yuan. Since February 7, 2003, U.S. dollar has weakened against the yuan. One U.S. dollar could be exchanged for 8.28 yuan at that time. The U.S. dollar has weakened because it can buy fewer yuan today, than it could in 2003.

That's because the U.S. government pressured the Chinese government to let the yuan rise in value. This allows U.S. exports to be more competitively priced in China. It also makes Chinese exports to the United States, more expensive.

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INFLATION RATES

Changes in inflation cause changes in currency exchange rates. Generally speaking, a country with a comparatively lower rate of inflation will see an appreciation in the value of its currency. The price of goods and services increases at a slower rate when inflation is low. Countries with a continually low inflation rate exhibit an increasing currency value, whereas a country with higher inflation typically experiences depreciation of its currency and this is usually accompanied by higher interest rates.

INTEREST RATES

Interest rates, inflation and exchange rates are all correlated. Central banks can influence both inflation and exchange rates by manipulating interest rates. Higher interest rates offer lenders a higher return compared to other countries. Any increase in a country's interest rate causes its currency to increase in value as higher interest rates mean higher rates to lenders, thus attracting more foreign capital, which in turn, creates an increase in exchange rates.

RECESSION

In the event a country's economy falls into a recession, its interest rates will be dropped, hindering its chances of acquiring foreign capital. The consequence of this is that its currency weakens in comparison to that of other countries, thereby lowering the exchange rate.

CURRENT ACCOUNT/ BALANCE OF PAYMENTS

A country's current account reflects its balance of trade and earnings on foreign investment. It comprises of the total number of transactions including exports, imports and debt. A deficit in its current account comes as a result of spending more of its currency on importing products than through exports. This has the effect of lowering the country's exchange rate to the point where domestic goods and services become cheaper than imports, thereby generating domestic sales and exports as the goods become cheaper on international markets.

TERMS OF TRADE

Terms of trade relate to a ratio which compares export prices to import prices. If the price of a country's exports increases by a higher rate than its imports, its terms of trade will have improved. Increasing terms of trade indicate a greater demand for a country's exports. This, in turn, results in an increase in revenue from exports which has the effect of raising the demand for the country's currency and an increase in its value. In the event the price of exports rises by a lower rate than its imports, the currency's value will decline in comparison to that of its trading partners.

POLITICAL STABILITY AND PERFORMANCE

A country's political state and economic performance can affect the strength of its currency. A country with a low risk of political unrest is more attractive to foreign investors, drawing investment away from other countries perceived to have more political and economic risk. An increase in foreign capital leads to the appreciation in the value of the country's currency, but countries prone to political tensions are likely to see a depreciation in the rate of their currency.

How does the government regulates exchange rates

The government regulates exchange rates only indirectly. That's because most exchange rates are set on the open foreign exchange market. In countries like China, where the rate is fixed, the government directly changes the rate.

The U.S. government has various tools to influence the U.S. dollar exchange rate against foreign currencies.

An independent arm of the government is the nation's central bank, the Federal Reserve. It indirectly changes exchanges rates when it raises or lowers the fed funds rate.

For example, if it lowers the rate, that drives down interest rates throughout the U.S. banking system. It also reduces the supply of money.

Both of those make the dollar stronger relative to other currencies. That's because U.S. dollar-denominated credit has become more expensive.

At the same time, dollar-denominated assets generate a higher return. Both create more demand for the dollar, while taking it out of circulation.

The laws of demand and supply tell you that less supply and more demand drives up the price. When that happens to the dollar, it can purchase more foreign currency on forex markets.

The Treasury Department is a government agency that also indirectly affects the exchange rate. It prints more money, which increases the supply, weakening the dollar. It can also borrow more money from other countries. That's done by selling Treasury notes. That not only increases the supply of money, it also increases the debt. Both will send the dollar's value down.

The third government tool is expansionary fiscal policies. They weaken the dollar by increasing the money supply. But these policies can also improve economic growth. That often makes investors demand more dollars as a safe haven. It's like a vote of confidence in the economy.

Sometimes this demand is so high that investors overlook the low interest rate they are getting by investing in dollars or U.S. Treasurys. The demand is even greater than the expansion in supply of dollars. Although the government is powerful in influencing exchange rates, it is still forex trading that actually changes them.

How does exchange rate affect you

GROCERIES

A strong dollar makes imports cheaper. That reduces inflation and lowers the cost of living. It allows you to buy more. More important, you could save more without harming your quality of life. Then you could save for a rainy day, or for retirement. A weak dollar makes import prices higher. That lowers your standard of living because you'll pay more for imported fruits, vegetables, and other groceries. It also causes inflation. That erodes your purchasing power over time.

OVERSEAS TRAVEL

The exchange rate tells you how much you can buy in your destination country. When the U.S. dollar is strong, you'll be able to buy more. If it's weak, then you might want to postpone the trip because everything will be more expensive. There's a way to avoid the exchange rate impact on your trip. You could go to one of the countries that pegs its currency to the dollar. That means a trip to that country won't become more expensive when the dollar declines. In the current economy, the dollar is relatively strong so it's a good time to go.

GAS

When the dollar rises in value against other currencies, gas prices fall. Why? More than 70 percent of the price of gas depends on oil prices. All oil contracts are sold in U.S. dollars. Saudi Arabia, who sells most of the world's oil, has pegged its currency to the dollar. When the dollar rises against the euro and other currencies, so does the riyal. That makes Saudi Arabia's imports cheaper. Therefore, Saudi Arabia can afford to charge lower prices for oil when the dollar rises. It still receives the same value from its imports. When the dollar weakens, gas prices rise. That's because SaudiArabia and the other OPEC nations must charge more for oil to receive the same revenue. Also, their import costs are higher, so they need more revenue to pay for expenses.

INVESTMENTS

A strong dollar can either help or hurt stocks. It depends on the reason. Investors buy dollars when they think the U.S. economy is strong. That means they are also more likely to invest in U.S. companies through the stock market. On the other hand, a strong dollar makes U.S. stocks more expensive. That might make U.S. stocks too expensive for foreign investors. A weakening dollar helps you if you already own foreign stocks. Those values will seem higher thanks to exchange rates. A weak dollar helps U.S. exports. This strengthens economic growth. It also makes U.S. stocks cheaper when compared to shares listed on foreign exchanges.

JOBS

A strong dollar is not good for U.S. business. That's because it means they can export less. Why? A strong dollar makes their products more expensive relative to foreign products. Over time, this slows economic growth. It also causes companies to outsource jobs overseas. That's because foreign workers cost less since they are paid in weaker currencies. A strong dollar even hurts companies that don't export. That's because they are now competing with cheaper imports. U.S. customers will buy those less expensive imports instead of those Made in America. The U.S. manufacturer must lower prices to remain competitive. That means less profitability. For those reasons, a strong dollar slows economic growth. It also results in fewer jobs for American workers.

LOANS

A strong dollar means that demand for U.S. Treasurys is also strong. That's because most countries buy Treasurys when they need to store U.S. currencies. They do that so their exporters can do business with America. When demand for Treasurys is high, that makes interest rates low. A strong dollar means loans are less expensive. That includes mortgages, auto loans, and school loans. It also keeps a lid on credit card debt rates, and adjustable-rate loans. For more, see Relation Between Treasury Notes and Mortgages. A weak dollar means interest rates higher. That's for two reasons. First, a weak dollar means there isn't enough demand for Treasurys. The U.S. government increases interest rates to attract more investors. Second, the Federal Reserve will raise the fed funds rate. Remember, a weak dollar means inflation. The Fed's goal is to keep inflation from going higher than 2 percent. The Fed will raise rates to strengthen the dollar, and curb inflation.

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