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The effects and consequences of exchange rates fluctuation on the economy

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Abstract
This essay examines the impact and influence on the exchange rate from a number of angles. First, this paper introduces the key variables that the exchange rate, export, prices, and costs influence. Productivity is the rise that results from the local currency's strength. Thus, it suggests that productivity is impacted by the exchange rate. The impact on the amount of tourists is the final influential aspect. Some recommendations for exchange rate policy are made after examining the effects of the exchange rate. The exchange rate is a crucial component, so it's important to prioritise both logical operation and wise policy application.

Keywords: Exchange rates, consumption, export price

Introduction

On the foreign exchange market, the exchange rate is the ratio of one currency to another. It is specifically used to confirm the value of a currency stated in terms of other currencies. The import and export trade between nations is directly regulated by fluctuations in the exchange rate. Changes in interest rates, inflation, national politics, and each country's economy all have an impact on exchange rates. The exchange rate is set by the foreign exchange market. It may be impacted by how one feels about what the market expects. An great market expectation is the likelihood of rising local currency. The local currency will strengthen in this scenario because it will be purchased in significant amounts. Additionally, macroeconomic policy has a bigger effect on the currency rate. For instance, a country's currency's external exchange rate will increase when it adopts a strict fiscal policy. In addition to these influences on the exchange rate, the exchange rate can have a number of consequences on many fundamental components. The following chart includes information on factors including consumption, export, price, productivity, and the number of foreign visitors. As a result, there are several exchange rate policies, including pegged exchange rates, fixed exchange rate policies, and floating exchange rate policies. The first part of this paper will investigate how the exchange rate is influenced and affected.

The impact of exchange rate on export price

The most important factor that will be impacted by the currency rate is export. The volume of export will rise if the local currency appreciates against the US dollar while the local currency depreciates. Thorbecke and Kato (2011) [4] claim that certain nations import goods from Japan and then reprocess them for export to other nations. The amount of export can be limited as long as the currency of the country doing the processing appreciates. Because of this, exports from countries that import from Japan are down as local currencies appreciate. Some claimed that the export situation in Japan might change this result. The quantity of exports from Japan is impacted by the distinctive export product that must be reprocessed once more and the decline in reprocessing and export. Thorbecke and Kato (2011) [4] established that the 30% appreciation of the Japanese yen will result in a 30% drop in exports of goods for consumption. This information demonstrated how crucial a role the currency rate plays in Japanese exports. Furthermore, the cost is frequently treated as an independent variable. The price, however, might be a dependent variable from the perspective of the exchange rate. According to Mathias (2015) [3], exchange rates have an impact on price increases and how difficult it is for sellers, distributors, and vendors to make decisions.

As an illustration, the rising value of the dollar contributed to rising component costs and rising market prices in the Eurozone. In addition, the tendency of steadily rising prices also emerged in the UK. The cost of maintenance and updating has been rising along with component pricing. In this situation, a huge number of industries would suffer negative effects, which would be bad for the economy's hope and anticipation.

The impact of exchange rate on consumption

It has been suggested that the exchange rate also affects consumption in some way. While local currency depreciation increases exports and reduces a country's competitiveness, it also has some impact on consumption. Because of the inflationary impacts of depreciation, the income of employees with high marginal propensities to consume (MPC) is transferred to producers with low MPC, which theoretically results in a drop in consumption. If a particular local currency gains value, it would be easier to buy goods from abroad. In this situation, purchasing and investing in foreign goods became affordable, which suggests that the volume of overseas consumption may rise. Domestic consumption is projected to decline as imported products consumption rises. Twelve samples were utilised by Oskooee, Kutan, and Xi (2015) [6] to calculate the exchange rate in the consumption function. The report's conclusion demonstrates how the nine samples' domestic consumption was impacted by the exchange rate. Currency depreciation lowers consumption, as demonstrated by the cases of Malaysia, Bolivia, the Czech Republic, Hungary, and the Czech Republic. Therefore, exchange rate volatility has an effect on domestic spending and may have an effect on how the economy grows.

The impact of exchange rate on productivity

The exchange rate may have an impact on productivity in addition to the previously listed considerations. Although it may seem that productivity and the exchange rate have nothing to do with one another, productivity is likely to rise as a result of the local currency's appreciation. According to Jeanneney and Hua (2010) [2], the fast rise in productivity in China was made possible by the RMB's appreciation. In China, it was discovered that appreciation encouraged productivity, which in turn encouraged the real exchange rate. Additionally, there are economic status inequalities between each city in China, and increased productivity could help close the gap. High productivity also contributes to making up for the loss of global expertise.

The impact of exchange rate on the number of foreign tourists

In the developing tourism market, exchange rate volatility is a major problem. In reality, the incremental exchange rate helps to facilitate the tourism business by having a positive impact on the number of international visitors. Figure 1 from Tung (2019)'s [5] investigation of the relationship between the exchange rate and the tourism industry from 2006 to 2018 depicts the volume of visitors to Vietnam during this time. The statistics, which were compiled on a monthly basis, showed that an increase in the exchange rate increased the number of tourists. Vietnam research is a helpful example for other rising markets. The tourism industry may empirically react to exchange rate changes. Granger investigated the causal link between the exchange rate and the quantity of foreign visitors and found a one-way relationship between the two variables. Therefore, the exchange rate might serve as a guide for decision-makers in the tourism industry, and those decision-makers could effectively react to the impact on the industry's economics. The importance of enhancing resort environments and satisfying visitors cannot be denied, though.

Conclusion

The analysis needs to be thorough because the exchange rate has a lot of effect and impact. This essay begins by examining the primary variables that the exchange rate affects, and it concludes that the impact on export is the most obvious and significant. The foreign currency market's price and cost are impacted by the change in exchange rates, and productivity is also impacted. The final element discussed in the essay is the proportion of international visitors, which demonstrates how a rise in the exchange rate increases the number of visitors. Following that, this essay presents four fundamental exchange rate policies with advantages and disadvantages to consider in various circumstances. The option with a variable exchange rate is the most popular globally. Furthermore, it is the central bank's duty to get involved and influence both the soft and hard pegs. It is demonstrated that there isn't a single best policy out there. The most suitable policy for a high-quality implemented country is the best result of using exchange rate policy. In conclusion, because the foreign exchange market and exchange rate are closely associated, a flourishing market environment might result from each country's rational operation and wise use of policy.

Suggestions

The exchange rate is a key component of the economic system that has an impact on a number of the previously mentioned important variables. Therefore, each nation should conduct its affairs wisely in order to minimize the impact of the exchange rate and the high danger of economic harm. The maintenance and improvement of the economy and international relations depend on both reasonable and lawful operations between each nation. The exchange rate systems and policies that a country adopts should be suitable for ensuring an acceptable exchange rate and supportive of economic growth. The three main exchange rate regimes are fixed exchange rate, floating exchange rate, and crawling pegged exchange rate. The recommendations will be demonstrated in the paragraph that follows.

With a floating exchange rate, the government is not required to regulate the exchange rate; instead, the foreign exchange market does it. Exchange rates will fluctuate in the short term for nations that opt for the floating exchange rate regime. The United States is one of many nations in the globe that choose for variable exchange rates. The tremendous wave of currency speculation is slowed down by the floating exchange rate since the speculator's potential gains are reduced by the rate's constant movement. Additionally, a country can use a floating exchange rate to improve its balance of payments by appreciating its own currency, which keeps a positive balance of payments from turning into a deficit. According to Sebastian (2007) [7], a flexible and variable exchange rate could lower the likelihood of experiencing a contraction in capital flow. The elastic exchange rate is more advantageous the more capital flows there are. However, increased foreign currency rates are available in international trade and financial activities thanks to the floating exchange rate. It erodes the fixed exchange rate system's monetary discipline. It promotes monetary policy's propensity for inflation so that governments are relieved of their responsibility to uphold fixed exchange rates through the suppression of inflation.

Another option is the fixed exchange rate, when the government establishes a particular exchange rate. The fixed exchange rate policy is advantageous for nations with export-oriented economy since it lowers the risk of change. The fixed exchange rate protects and secures GDP because import and export can contribute significantly to a nation's GDP.

Additionally, a soft peg is the term for the policy that lets the market determines the exchange rate, and the central bank would intervene in the market when the exchange rate is rising or falling. Another such measure known as a "hard peg" aims to maintain a constant exchange rate without short-term swings. In both the soft peg and the hard peg, the central bank may intervene. Government involvement could help prevent the economy from entering a recession brought on by a crisis or a harmful one-sided adjustment in the exchange rate. According to exchange-rate rules, soft peg policies maintain the reasonable cost of foreign exchange reserves and modify over time to lower the risk of becoming stranded. However, if a nation fixes the exchange rate, it will forfeit the ability to conduct monetary policy, which could result in greater volatility on the foreign currency market. Additionally, when a nation with a pegged exchange rate experiences inflation or a recession, monetary policy can be used to either modify the exchange rate or deal with the inflation and recession. Reducing interest rates and implementing an expansionary monetary policy result in a decrease in demand and an increase in supply. Following that, the exchange rate depreciates and obeys the hard peg. In this situation, a conscious trade-off between monetary policy and exchange rate is required. The currency rate policies are balanced out in table 1.

Table 1: Table of exchange rate policies

Situation	Floating Exchange Rates	Soft Peg	Hard Peg
Large short-run fluctuations in exchange rates?	Often a lot in the short term	Maybe less in the short run, but still large changes over time	None, unless a change in the fixed rate
Large long-term fluctuations in exchange rates?	Can often happen	Can often happen	Cannot happen unless hard peg changes, in which case substantial volatility can occur
Power of central bank to conduct countercyclical monetary policy?	Flexible exchange rates make monetary policy stronger	Some power, although conflicts may arise between exchange rate policy and countercyclical policy	Very little; central bank must keep exchange rate fixed
Costs of holding foreign exchange reserves?	Do not need to hold reserves	Hold moderate reserves that rise and fall over time	Hold large reserves
Risk of being stuck with an exchange rate that causes a large trade imbalance and very high inflows or outflows of financial capital?	Adjusts often	Adjusts over the medium term, if not the short term	May become stuck over time either far above or below the market level

There is no set regulation that specifies which exchange rate policies must be used to lessen the exchange rate's detrimental effects. Exchange-rate policies (unknown) propose that nations achieve the four economic goals of consistent economic growth, low inflation, low unemployment, and sustainable trade balance in order to become more and more prosperous. A change in exchange rates will not help countries who do not meet the four economic benchmarks. It is crucial to have a thorough and comprehensive exchange rate policy. Furthermore, choosing a sensible and suitable currency rate policy requires a correct grasp of a country's operational system and competence. Although there isn't a confirmed optimum exchange rate policy, the best policy is the one that is most appropriate for the regional economic environment.

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