Foreign Exchange Risk and Macroeconomic Determinants in International Business

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Introduction

International business refers to the business activities undertaken across the international borders of two or more countries. In this case, the trader is usually from one country and selling his or her products to a buyer in another country. International business is very instrumental in promoting market growth and expansion, especially in the sense that international markets facilitate an increase in the sales volume of a company. Nonetheless, there are some challenges or risks that international business traders face in the course of undertaking their business activities, key among them foreign exchange risks (Engle, 2014). The fact that the trader and the buyer come from two different countries simply means that the two players also have different local currencies. In this case, they will face a foreign exchange risk, as the buyer will have to exchange his local currency for that which is acceptable to the trader before he or she can buy the goods or services he or she is selling. Take, for instance, a US consumer purchasing products from Australia; the buyer will have to convert his currency into local Australian dollars to make purchases.

However, this process may end up raising or lowering the cost of a business transaction depending on the applicable foreign exchange rates. These rates refer to the rates at which the Australian dollar exchanges for the US dollar, given the case study above involving a US buyer and an Australian trader. Therefore, if the US dollar is stronger than the Australian dollar, the US consumer will spend less on purchasing his or her product from the Australian trader. On the other hand, if the Australian dollar is stronger than the US dollar, then the US customer will spend more on purchasing the product from the Australian trader (Chaboud et al., 2014). This is the impact of foreign exchange rates on international business, in addition to the manner in which it controls economic activities within a given setup. In the following case study, the focus will be on the exchange rates for Australian dollars and US dollars and the impact on the cost of undertaking international business within the two countries.

Data Collection And Data Transformation

The Australian dollar has grown to become an important currency in the foreign market, a fact largely attributable to the increase in the number of foreign investors who inject cash flows into the Australian market. As such, this has facilitated significant growth in the level of international business reported between the Australian markets and other international markets across the world. However, the primary area of concern is the fact foreign investors in Australia face foreign exchange risks arising from the need to change their local currencies into Australian dollars to facilitate trading activities within the Australian market (Engel, 2014). Furthermore, the fact that the exchange rate of Australian dollars to various foreign currencies has been fluctuating over the years makes matters even riskier, especially in the case of free-floating foreign currency on the exchange rate.

In this assignment, the US dollar was used to evaluate the impact of foreign exchange rates on the prospects of international business within the Australian market (Hodrick, 2014). The case study involving the US buyer purchasing products from the Australian market is what was applied in this particular case. In this regard, forex exchange data for the USD against the AUD was collected and analyzed for the past 20 years, starting January 1, 2000, to date. The data on the foreign exchange rates of the USD and the AUD was collected from MyFXBook, which details historical records of foreign exchanges of different currencies across the globe. The following link shows the site where the data collected and used for this analysis were collected from Australian Dollar versus US Dollar, retrieved from OFX.com https://www.ofx.com/en-au/forex-news/historical-exchange-rates/

The data was analyzed for transformation regarding the percentage change in foreign currency value as well as the standard deviation of percentage change in the foreign currency value over the years. Conversely, this would allow for appropriate determination of the degree of risk associated with each currency, in addition to establishing the fact as to whether or not the US currency trading in the Australian market is either stronger or weaker and if there are any risks involved in the trading activities.

Empirical Analysis

The empirical analysis of the foreign exchange rates between the USD and the AUD provides that the mean of the exchange rates over the past 20 years was about 0.7. This is because the USD was stronger than the AUD (Ghosh, Ostry & Chamon, 2016). As such, the average exchange rate for every AUD was given as 0.77 with a fluctuating margin ranging between -1 and +3, whereby the lowest exchange rate reported during the period was 0.6 USD for every one AUD, meaning that the Australian dollar had gained on the US dollar and become a lot stronger, while the highest exchange rate reported during the period was 1.1 USD for every one AUD, meaning that the Australian dollar had weakened to the US dollar and become weaker. Therefore, it is notable that the Australian market has been fairly stable compared to the US market, and this is the reason why even the changes in the standard deviation range were not badly off. For instance, the lowest value of standard deviation obtained during the period was -19.25%, while the highest value of the standard deviation obtained during the period analyzed was 9.6%.

Considering the fact that the exchange rate between the AUD and USD was free-floating, it is appropriate to assert that the forces of demand and supply were the ones responsible for the changes reported in the exchange rates, in which case caused the fluctuations of the exchange rates to rise and fall according to the market forces (Penrose, 2017). In essence, it is notable that when the Australian economy improved and became stronger, the exchange rate of its currency to the US dollar reduced to the lows of 0.6 and 0.7, respectively. On the other hand, it is also notable that when the Australian economy failed and became weaker, the exchange rate of its currency to the US dollar increased to the highs of 1.0 and 1.1, respectively. A table showing the transformations in the exchange rates for the AUD against the USD is given below in the Appendix and the Excel spreadsheet attached, respectively, while the regression analysis showing how these transformations were recorded during the 20-year period is also given in the Excel.

In the graph provided, the period noted to have the highest exchange rate for the USD for each single AUD was between 2011 and 2013. This was a period when the country's economy was recovering from the negative aftermath of the global economic crisis that had affected the global economy in 2008. As such, it is appropriate to assert that the transformations in economic stability in Australia are among the primary reasons that led to the stifling of the AUD against the USD (Moore & Wang, 2014). Nonetheless, of the two currencies, it is appropriate to assert that they both have a similar degree of stability in that the range of transformation in their exchange rates did not change significantly over the 20-year period. Nonetheless, given a comparative analysis, the currency that would be considered the riskiest among the two is the Australian Dollar, as the empirical analysis shows how it weakened against the USD during the period of the analysis.

From the above empirical analysis, it is worth noting that some macroeconomic variables play a critical role in determining the foreign exchange rate applied for the local currency against any other foreign currency (Tenti, 2017). Some of these macroeconomic variables that affect the performance of the foreign exchange rate include the inflation rate, interest rates, and the national income, sometimes referred to as the Gross Domestic Product (GDP), the Gross National Income (GNI) or the Per Capita Income (PPI). Given the monthly exchange rate reviewed in this particular case study, it is imperative to note that other factors may as well affect the exchange rate of the AUD against the USD, which includes the stock market, the net trade balance, as well as the balance of payments reported within the economy over a given period.

- Inflation Rate

The inflation rate affects the exchange rate both positively and negatively depending on its transformations. Nonetheless, it is noteworthy from the very start that a high inflation rate leads to a high foreign exchange rate, while a low inflation rate leads to a low foreign exchange rate. The reason for this assertion is that a high inflation rate within the economy increases the risk of doing business, in addition to raising the cost of operations for companies and businesses (Saarinen, 2015). As such, the final price of products and services will increase significantly because of the high inflation rates in the country, making the cost of living very high and, subsequently, leading to the loss of the value of money.

During high inflation, one AUD will purchase very little compared to a period of low inflation, whereby one AUD will purchase a lot. As a result of the high inflation, the economy becomes unstable and starts weakening compared to other international economies. Subsequently, the exchange rates of the country's currency with those of other world powers will fall drastically. In the same regard, when inflation drops and the economy strengthens, the local currency gains against the foreign currency, subsequently reducing the foreign exchange rate. Therefore, from this analogy, it is noteworthy that the rate of inflation has a significant impact on the foreign exchange rate of a local currency against any foreign currency.

- Interest Rate

Interest rates also affect the foreign exchange rate in the sense that they, too, affect the economic performance of the country. The reason for this assertion is that foreign exchange rates are largely attributable to the economic performance of a country, whereby the stronger a country's economy is, the stronger its local currency to other foreign currencies, and vice versa (Chaboud et al., 2014). The rate of interest has a positive as well as negative impact on the economy of a country based on the nature of the transformations registered. On the one hand, a high interest rate stifles economic growth and development by first reducing the cost of operations and the circular flow of money and increasing the cost of investments. On the other hand, a low interest rate promotes economic growth and development, thereby making a country's economy stable and stronger. In this case, it is noteworthy that a high interest rate will lead to a rise in the foreign exchange rate of the local currency against a foreign currency, while a low interest rate would lead to falling in the foreign exchange rate of the local currency against a foreign currency.

- National Income

The national income of a country, as evidenced by its GDP, PPI, and GNI, has a significant effect on the foreign exchange rates as it determines the economic stability of the country. This is especially true because a high national income will result in a stable economy, while a low national income will result in an unstable economy (Blanchard & Adler, 2015). Conversely, a high national income will result in a low foreign exchange rate as the local economy is stronger compared to other international economies, whereby the local currency gains significantly on the foreign currencies, while a low national income will result in a high foreign exchange rate as the local economy is weaker to the other international economies, whereby the local currency also looses significantly to the foreign currencies.

Summary And Conclusions

In conclusion, it is evident that foreign exchange rates play a critical role in determining the degree of success registered by a country in international trade. The reason for this assertion is that the foreign exchange rates determine the cost of products and services exported from the country to other countries and, as such, establish the cost of international trade. Furthermore, it is also notable that various key factors, including the interest rate, the inflation rate, and the national income, also have a significant effect on the foreign exchange rates reported.