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A Study on the Causes of Two-Way Exchange Rate Fluctuations, Their Economic Effects, and Multi-Dimensional Response Strategies

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Abstract: Given the current economic situation, this paper will investigate the reasons for exchange rate changes by examining factors such as inflation and deflation, the country's domestic economic environment, market speculation, etc. It will analyze the positive and negative effects of both currency appreciation and depreciation, explain how changes in the exchange rate affect countries, enterprises and individuals, the scale of national import and export trade, operating costs of foreign-trade enterprises, and household asset investments. Given the risks and development opportunities arising from exchange rate changes, this paper will examine how countries, enterprises and individuals should deal with the economic impact of exchange rate fluctuations from the perspectives of national policy regulation, corporate operational adjustment and household asset allocation, in order to reduce the shock of exchange rate volatility and utilize the development advantages of such fluctuations.

Keywords: Exchange Rate Fluctuations; Response Strategies; Trade Impacts

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Introduction

Exchange rates affect the development of a country's trade, economic stability and foreign exchange reserves; changes in the exchange rate can have an impact on the economy and the operation of enterprises in related sectors. Zimbabwe is a typical case; by 2008, due to a number of reasons, such as extensive currency over-emission by the government, a drop in domestic agricultural output and foreign economic sanctions, hyperinflation had occurred and reached 79.6 billion per cent per month. Foreign exchange reserves dropped to a very low level and the economy was about to collapse. It can be seen that no other country would want to be in this situation; therefore, we need to study the reasons for the fluctuation of the exchange rate and the relevant policies.

1. A Detailed Discussion of the Causes of Exchange Rate Fluctuations

1.1 Inflation and Deflation

Rising domestic inflation in a country will raise prices for consumers and reduce the buying power of their money. If the outside environment is stable, it will be relatively low-pressure on the currency. Capital seeks to maintain its value and thus increases the proportion of foreign assets, further weakening the domestic currency. When a person wants to conduct a

transaction at the old exchange rate, no one will agree to it; they need to use more of their own money to exchange for foreign currency first. On the other hand, the effect of deflation on exchange rates should also be considered in light of all these factors: if the cause of deflation is technological progress and improved production efficiency, then the enhanced international competitiveness of domestic goods will support the exchange rate of the domestic currency; if deflation results from an economic downturn or insufficient domestic demand, then market expectations for the domestic economy will decline, leading to increased capital outflows and a corresponding depreciation of the domestic currency.

1.2 National Economic Situation

A country's economic power is a prolonged support for the exchange rate. Generally speaking, a healthy economy will have steady growth in GDP, low inflation, reasonable interest rates and a relatively balanced balance of payments. A good economy will increase people's confidence in investing, strengthen the yuan, and boost the amount of money used by domestic residents for consumption, thus promoting economic health and stability of exchange rates.

1.3 Market Speculation and Forecasts

Changes in the economy and other reasons will make people expect fluctuations in foreign exchange markets, causing currency volatility. For example, before the Federal Reserve raised interest rates in 2022, the market had already factored in an increase in the interest rate differential, and as a result, the US dollar had risen. Dollar Index and the broad pressure on emerging market currencies; the South Korean won fell by more than 12 per cent that year. When investors are optimistic about the market and economy in China, they will invest more money, increase the demand for the yuan, and thus raise the exchange rate. Conversely, if investors are pessimistic about the economy in China, they will move their funds to safer places beforehand, causing capital to leave and the exchange rate to drop sharply[1].

2. Special Effects of Exchange Rates

2.1 Negative Effects and Risks

2.1.1 Negative Effects of Appreciation

Currency appreciation will reduce the profits of the exporting company. For example, if a company imports rice cookers from China at a cost of 100 yuan per unit per year. When the USD/CNY exchange rate is 7.3, and other factors are ignored, selling the rice cookers in the United States for $14 each will yield a considerable profit; however, if the USD/CNY exchange rate falls to 6.8, the revenue in RMB will be only 95.2 yuan, which is less than the 100-yuan cost, and the company will incur a loss[2].

2.1.2 Negative Effects of Depreciation

Currency depreciation will increase the amount of foreign debt. For instance, if a Chinese company has taken out a 10-billion-US-dollar foreign loan but has no foreign-currency income to offset the risk, and the Renminbi weakens significantly during the repayment period—for example, from 1:6.8 to 1:7.3 (RMB:USD)—then the amount of debt repayment in RMB will rise from 68 billion yuan to 73 billion yuan, and a foreign-exchange loss of 5 billion yuan will occur; thus, the cost of debt servicing will be increased. In practice, many companies have used forward foreign exchange contracts to fix the exchange rate and hedge against foreign debt exchange rate risk.

2.2 Positive Effects

2.2.1 Positive Effects of Appreciation

An increase in RMB reduces the cost of imports. For example, if a Chinese company wants to purchase soybeans from the United States at a price of $534 per metric ton, and the RMB-to-USD exchange rate is 1:7.3, then it will need to pay 3,898.2 yuan to buy one metric ton of soybeans. However, if the USD-to-RMB exchange rate drops from 7.3 to 6.8, the RMB will strengthen, and the company will only need to pay 3,631.2 yuan in RMB to buy one tonne of soybeans. Thus, the company's procurement costs will be reduced; the same amount of currency can buy more soybeans.

2.2.2 Positive Effects of Depreciation

A depreciation of the RMB leads to an increase in the price of imported goods and thus promotes the development of domestic industries. For instance, if a Chinese company and an American company sell the same product, the American company can lower its costs and thus offer the product at a lower price than the Chinese company. If the Renminbi weakens,

then the price of imported goods in Renminbi will rise; thus, foreign products will lose their price advantage over domestic products and become less competitive. More people will choose the Chinese company, and as a result, the growth of the Chinese company will create more jobs and increase the country's GDP.

3. Countermeasures Against Fluctuations in Exchange Rates

3.1 Management of Risks of Adverse Effects

National Policies, Corporate Business Strategies and Individual Investment Preferences

3.1.1 Management at the National Policy Level

As shown above, the negative effects of appreciation will disturb the foreign exchange market. To address the above issues, the government can take two measures: the central bank will adjust the exchange rate, and subsidies for foreign-currency enterprises will be issued by the government. If the RMB is under depreciation pressure (e.g., the USD/CNY exchange rate rises from 6.8:1 to 7.3:1), the central bank can stabilize the exchange rate by selling US dollar reserves and withdrawing RMB from the market to tighten domestic currency liquidity; it can also reduce the depreciation pressure by raising the foreign exchange reserve requirement ratio and thereby freezing a portion of the foreign exchange funds of financial institutions and reducing the supply of US dollars in the market. If the Renminbi strengthens too rapidly (e.g., if the exchange rate drops from 7.3:1 to 6.8:1), the central bank will lower the foreign exchange reserve requirement ratio to release some of the foreign currency liquidity held by financial institutions, increase the supply of US dollars in the market, and thus restrain the rapid appreciation of the Renminbi.

Given the pressure on external debt and import costs due to the drop in the RMB, the central bank can also boost exchange rate stability and restore market confidence in the RMB by releasing foreign currency and tightening controls on cross-border capital outflows[3]. At the same time, it can reduce the amount of tariffs on essential raw materials and consumer goods to lower import costs and curb import-driven inflation; for non-essential items, it can increase import tariffs to control excessive demand for imports and reduce the outflow of foreign currency.

3.1.2 Modifications of Corporate Business Strategies

If the Renminbi strengthens, the overseas competitiveness of export-oriented enterprises will weaken, and the purchasing power of the same amount of US dollars in Renminbi will fall. The company can either raise the price of the goods by increasing the cost and pass it on to the consumer, or increase the quantity sold by reducing the cost of production.

Alternatively, the company may choose to build a factory abroad first and then produce and sell locally. With the rise of the Renminbi, the costs of establishing overseas bases of production have fallen, and now it is more economical to import raw materials and manufacture abroad. Fuyao Glass built a plant in the US to obtain raw materials locally and manufacture there; thus, it avoided large losses on currency conversion of profits back to RMB.

If the RMB depreciates, the cost of imported raw materials will rise, and then enterprises will be motivated to source, produce and manufacture domestically. Conversely, companies producing abroad will have their RMB revenue rise after converting dollar profits back into RMB due to currency depreciation and are thus favoured by overseas profit performance. If the company expects depreciation to continue, it will increase the pace of repatriation and conversion of overseas profits to secure higher RMB exchange gains; if it expects sustained appreciation, it will reduce the speed of conversion or extend payment terms to delay the conversion of foreign-currency assets and avoid exchange losses.

3.1.3 Changes in People's Investment Ideas

If the Renminbi strengthens, the amount of foreign currency assets in Chinese terms will decrease, and people may reduce their holdings of foreign currencies and overseas real estate and increase their holdings of RMB-denominated assets. As the domestic currency strengthens, people are more likely to think that the economy is doing well and will invest more in high-risk assets such as stocks and mutual funds.

If the Renminbi depreciates, gold may rise in domestic prices because it has historically served as an inflation hedge; however, fluctuations in the US Dollar globally and shifts in supply and demand for other commodities will also affect gold prices.

3.2 How to Utilize the Good Effects

3.2.1 RMB Appreciation

RMB appreciation refers to a decline in the prices of foreign goods when expressed in RMB. To make better use of this, we can import the raw materials or set up a production base abroad. Fuyao Glass has set up production bases in the United States for many years as an example. Given that the company is in an area with low energy costs and does not have to pay import and export tariffs, it can reduce the negative impact of RMB exchange rate fluctuations on export profits. It is a typical case of how overseas localisation can reduce exchange rate risk[4].

When the Renminbi is weaker, foreign buyers can purchase our goods at a lower cost and earn more profit from exports; thus, companies are not in a hurry to build factories abroad. At this time, exchanging RMB for foreign currency to purchase land and machinery is out of reach for many people, and the cost of establishing overseas factories will be relatively high. By producing the goods at home and selling them abroad, then converting the foreign currency back to RMB for profit, companies are busy expanding domestic production lines to win overseas orders. Loans taken out abroad must now be repaid in more domestic currency, so the need for additional borrowing to build factories is very high. Develop the domestic supply chain and use the favourable exchange rate to increase the competitiveness of domestic products; those with existing overseas factories keep the foreign currency earnings abroad, convert back to RMB only as necessary, avoid excessive spending on overseas expansion, and instead focus on reaping the benefits of exports[5].

4. Summary and Outlook

Fluctuations in exchange rates are caused by many factors, such as inflation, the health of a country's economy, market speculation, etc., and they have a dual impact on the economy, trade, business operations and the lives of ordinary people. A strong domestic currency can help reduce the cost of imports and motivate enterprises to expand overseas, but it may also weaken export competitiveness; a weak domestic currency can boost exports and drive growth in domestic industries, but it will increase import costs, raise external debt pressure and inflation risk. Considering the opportunities and risks of changes in exchange rates, the government, enterprises and individuals all need to make timely adjustments. The government has created a good market environment with monetary policy, exchange rate control and tariff policies; enterprises are reducing exchange rate risk by industrial upgrading and going global; and residents have adjusted their asset allocation in response to exchange rate changes. Given the changes in the world's financial system, there will be high fluctuations in exchange rates for a long time. Only by working together and adjusting their strategies flexibly can all parties make good use of the good effects of exchange rates and promote the continuous and healthy development of the domestic economy and foreign trade.

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Conflict of Interests

The authors declare that there is no conflict of interest regarding the publication of this paper.

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