

Impact Of The Floating Exchange Rate On The Economy

Author: Ifeoma Obi . June 2020

A floating exchange rate is a regime where the currency price of a nation is set by the forex market based on supply and demand relative to other currencies. This is in contrast to a fixed exchange rate, in which the government entirely or predominantly determines the rate. Floating exchange rate systems mean long-term currency price changes reflect relative economic strength and interest rate differentials between countries. Short-term moves in a floating exchange rate currency reflect speculation, rumors, disasters, and everyday supply and demand for the currency. If supply outstrips demand that currency will fall, and if demand outstrips supply that currency will rise. The floating rate is usually determined by the open market through supply and demand. Therefore, if the demand for the currency is high, the value will increase. The main concept of demand and supply also applies in the DeFi world. Moreover, you can find the rates on the [best cryptocurrency exchanges](#).

Asset pricing theories generally concern the pricing of assets, as shown by Chen, Roll, and Ross (1986) in a study based on Ross' (1976) arbitrage pricing theory. The exchange rate ought to exert some influence on the stock returns at the aggregate level in a world of exchange rate volatility, where the level of uncertainty is determined by expectations of respective investors or economic agents regarding the market's valuation of risk and returns of assets. Following the 1973 collapse of the Bretton Woods system (rules on exchange rate management) and the subsequent introduction of a newer free-floating exchange rate regime, the focus of empirical studies in finance shifted to the role of exchange rates in individual asset pricing. The CAPM-based model was initially tested to measure the exchange rate risk of individual firms directly exposed to exchange rate volatility. Jorion (1990) found that the exchange rate risk is priced for individual stocks with correlation coefficients ranging between 0.05 and 0.10, depending on the level of a firm's operation in international markets.

Furthermore literature provides evidence from major studies generally addressing the international pricing of broad-based stock indices at macro level using the so-called "integrated market models". A seminal study of this type was developed by Roll (1992), linking the stock index returns to monetary phenomena such as behavior of inflation and exchange rates, as well as each of the 23 sampled country's industry structure. Ferson and Harvey (1993) applied a conditional form of international asset pricing of stock index returns using exchange rates, inflation, interest rates, international default risk, and the world industrial production. Another study by Ferson and Harvey (1994) reported supporting evidence.

Dumas and Solnik (1995) applied the single-factor model of Adler and Dumas (1984) and reported that the model holds statistically for the exchange rate effect on stock index returns in four countries. Likewise, De Santis and Gerard (1998) applied the single-factor model for exchange rates and stock index returns in selected countries, confirming support for the model. Patro, Wald, and Wu (2002) reported supporting evidence for a time-varying foreign exchange effect on stock index returns as well. A recent study (Chen, Hong, & Ren, 2016) finds evidence of cointegration between durable

consumption and asset returns. A common feature of these studies is clearly concerned with the use of world market portfolio (world index) as an independent variable explaining the returns of broad-based equity indices. The use of industrial production is also found to be a usual practice in asset pricing model specification since it captures an economic variable used in tests of arbitrage pricing theory. Such studies used industrial production index as a proxy for macroeconomic factor.

Previous research on the impact of exchange rates on stock index returns provides evidence of a significant exchange rate effect on stock index returns using data from seven selected countries practicing free-floating exchange rate regimes. This research uses parity and asset pricing theories, thus placing it within the monetary-cum-economics framework for international asset pricing. In this study, a system of seemingly unrelated regression to control for unobserved heterogeneity and cross-sectional dependence was applied. The findings constitute evidence of a statistically significant exchange rate impact on stock index returns across selected countries. These findings can be considered as falling under the arbitrage pricing approach of international capital asset pricing model of Solnik who also used the parity-theoretical framework on exchange rate determination.

Thus, in the spirit of Ross (1976), who initially coined the arbitrage approach to asset pricing, the research too used the macro- coefficients ranging between 0.05 and 0.10, depending on the level of a firm's operation in international markets. Bahmani-Oskooee and Saha (2016) took this research a step further and examined the asymmetric effect of exchange rate changes on stock index prices using a nonlinear auto-regressive distributed lags approach, whose findings provided evidence of an asymmetric effect of nominal effective exchange rates on stock index prices in the short run only. The study did not take into account an evaluation of the long-term effects of exchange rates on stock prices, since these models generally lead to unstable findings. Their model specification is therefore distinguished from the ones reviewed in this section.

Economies with a strong influence of capital control, such as China, show less significant effects of exchange rate movement on firm value than other sample economies with a free capital control. Therefore with reference to the prices and the prices of selected assets on the Zimbabwe Stock Exchange, the floating exchange rate would lead to more significant effects of the exchange rate on the prices and pricing of selected assets on the ZSE. A floating exchange rate would affect companies that trade in the local currency for example Fidelity Life Holdings differently from the way it would affect companies that trade in foreign currency for example BAT.

In a situation whereby the floating exchange rate's volatility is short term, local businesses that trade in local currency that will need foreign currency to import their goods from outside the country. Therefore, those who trade locally and earn in the local currency are at a high risk due to the devaluation of the local currency especially when they are supposed to import their stock. They will need to purchase foreign currency in order to purchase their goods for trade. The continuous devaluation of the local currency will mean the purchasing power of the local currency will continue to decrease and the amount of goods they will be able to purchase with the same amount will continue to decrease. Therefore, the stock price of such a company will decrease.

On the other hand, companies that export goods and trade in foreign currency are affected to a lesser

extent by the volatility that accompanies the floating exchange rate because the foreign currency hardly changes its purchasing power because it is more stable than the local currency. This as a result will lead to stock prices of such companies remaining stagnant or even rising. This is because the floating exchange rate will make goods cheaper and holding all factors constant it means consumers from richer countries can import from such a country and the country will therefore, earn forex in the form of foreign direct investment. This will lead to an increase in shareholder value which will lead to the prices or pricing of the selected assets of these companies rising on the stock exchange. If the floating exchange rate's volatility is long term, this means the prices and pricing of selected asset for companies on the stock exchange that trade both locally and internationally will become stable.

References

1. "Fixed Exchange Rates and Floating Exchange Rates: What Have We Learned?"
Www.Everycrsreport.Com, www.everycrsreport.com/reports/RL31204.html#:~:text=The%20ma in%20economic%20advantages%20of. Accessed 15 June 2020.

Ifeoma is a Business Analytics and Research Consultant at Industrial Psychology Consultants (Pvt) Ltd, a business management and human resources consulting firm.

LinkedIn: <https://www.linkedin.com/in/ifeoma-obi-92b4b9121/>

Phone: +263 242 481946-48/481950

Mobile: +263 775 187 283

Email: ifeoma@ipcconsultants.com

Main Website: www.ipcconsultants.com

<https://thehumancapitalhub.com/articles/Impact-Of-The-Floating-Exchange-Rate-On-The-Economy>