Foreign exchange markets and Balance of payments

Foreign exchange markets are made up of banks, forex dealers, commercial companies, central banks, investment management firms, hedge funds, retail forex dealers and investors.

The balance of payments (BOP) is a statement of all transactions made between entities in one country and the rest of the world over a defined period of time, such as a quarter or a year.

How Does the Balance of Payments Impact Currency Exchange Rates?

A change in a country's balance of payments can cause fluctuations in the exchange rate between its currency and foreign currencies. The reverse is also true when a fluctuation in relative currency strength can alter the balance of payments . There are two different and interrelated markets at work: the market for all financial transactions on the international market (balance of payments) and the supply and demand for a specific currency (exchange rate).

These conditions only exist under a free or floating exchange rate regime. The balance of payments does not impact the exchange rate in a fixed-rate system because central banks adjust currency flows to offset the international exchange of funds.

The world has not operated under any single rule-based or fixed exchange-rate system since the end of Bretton Woods in the 1970s.

To explain further, suppose a consumer in France wants to purchase goods from an American company. The American company is not likely to accept euros as payment; it wants U.S. dollars. Somehow the French consumer needs to purchase dollars (ostensibly by selling euros in the forex market) and exchange them for the American product. Today, most of these exchanges are automated through an intermediary so that the individual consumer doesn't have to enter the forex market to make an online purchase. After the trade is made, it is recorded in the current account portion of the balance of payments.

The same holds true for investments, loans, or other capital flows . American companies normally do not want foreign currencies to finance their operations, thus their expectation for foreign investors to send them dollars. In this scenario, capital flows between countries show up in the capital account portion of the balance of payments.

As more U.S. dollars are demanded to satisfy the needs of foreign investors or consumers, upward pressure is placed on the price of dollars. Put another way: it costs relatively more to exchange for dollars, in terms of foreign currencies.

The exchange rate for dollars may not rise if other factors are concurrently pushing down the value of dollars. For example, expansionary monetary policy might increase the supply of dollars.

Which Factors Can Influence a Country's Balance of Trade?

1 Factor Endowments

Factor endowments include labor, land, and capital. Labor describes the characteristics of the workforce. Land describes the natural resources available, such as timber or oil. Capital resources include infrastructure and production capacity. The productivity of those factors is also essential. For example, suppose two countries have the same amount of labor and land endowments. However, one country has a skilled labor force and highly productive land resources, while the other has an unskilled labor force and relatively low-productivity resources. The skilled labor force can produce relatively more per person than the unskilled force, which in turn influences the types of work in which each can find a comparative advantage. The country with skilled labor might be better-suited to designing highly complex electronics, while the unskilled

labor force might specialize in simple manufacturing. Similarly, the efficient use of natural resources can mean relatively more or less value extracted from a similar initial endowment.

2 Trade Policies

Barriers to trade also affect the balance of exports and imports for a given country. Policies that restrict imports or subsidize exports change the relative prices of those goods, making it more or less attractive to import or export. For example, agricultural subsidies might reduce the cost of agricultural activities, encouraging more production for export. Import quotas raise the relative prices of imported goods, which reduces demand.

Nations that are insular and have restrictive trade policies such as high import tariffs and duties may have larger trade deficits than countries with open trade policies, since they may be shut out of export markets because of these impediments to free trade.

There are also non-tariff barriers to trade. A lack of infrastructure is a notable one, as it can increase the relative cost of getting goods to market. This increases the price for those products and reduces a nation's competitiveness on the global market, which in turn reduces exports. Investment can work to reduce these barriers. For example, investments in infrastructure can increase a nation's capital base and reduce the price of getting goods to market.

3 Exchange Rates, Foreign Currency Reserves, and Inflation

- **Exchange rates**: A domestic currency that has appreciated significantly may pose a challenge to the cost-competitiveness of exporters, who may find themselves priced out of export markets. This may pressure a nation’s trade balance.
- **Foreign currency reserves**: To compete effectively in extremely competitive international markets, a nation has to have access to imported machinery that enhances productivity, which may be difficult if forex reserves are inadequate.
- **Inflation**: If inflation is running rampant in a country, the price to produce a unit of a product may be higher than the price in a lower-inflation country. This would affect exports, affecting the trade balance.

4 Demand

Demand for particular products or services is an essential component of international trade. For example, the demand for oil affects the price and thus, the trade balance of oil-exporting and oil-importing countries alike. If a small oil importer faces a falling oil price, its overall imports might fall. The oil exporter, on the other hand, might see its exports fall. Depending on the relative importance of a particular good for a country, such demand shifts can have an impact on the overall balance of trade.

5 Trade Balance as an Economic Indicator

The utility of trade balance data as an economic indicator depends on the nation. The most significant impact is generally seen in nations with limited foreign exchange reserves, where the release of trade data can trigger large swings in their currencies.

The trade data is usually the largest component of the current account, which is closely monitored by investors and market professionals for indications of the economy's health. The current account deficit as a percentage of gross domestic product (GDP), in particular, is tracked for signs that the deficit is becoming unmanageable and could be a precursor to a devaluation of the currency.

However, a temporary trade deficit may be viewed as a necessary evil, since it may suggest that the economy is growing strongly and needs imports to maintain the momentum.

The balance of trade is a key indicator of a nation’s health. In general, investors and market professionals appear more concerned with trade deficits than trade surpluses, since chronic deficits may be a precursor to a currency devaluation.