

How Exchange Rates Influence International Business

The factors that affect exchange rate determination are complex and constantly in flux. Therefore, an in-depth understanding of these factors is needed to inform accurate risk analysis and strategic managerial decision-making in the international arena.

What is a Currency Exchange Rate?

According to Inc., “An international exchange rate, also known as a foreign exchange (FX) rate, is the price of one country’s currency in terms of another country’s currency.”

For example, if the value of one U.S. dollar (USD) is equal to the value of 20 Mexican Pesos (MXN), the USD/MXN exchange rate would be 20. Or, in the more spelled out form, 1 USD = 20 MXN.

“Floating” exchange rates can constantly fluctuate due to numerous factors. However, some countries have established a relatively constant “fixed” or “pegged” exchange rate with other select countries.

For instance, the Hong Kong dollar (HKD) has been pegged to the USD with an exchange rate of between 7.75 to 7.85 for nearly four decades. As [Investopedia](#) notes, “Pegging a currency stabilizes the exchange rate between countries. Doing so provides long-term predictability of exchange rates for business planning.”

What Factors Influence Exchange Rate Fluctuations?

The most fundamental determinant of floating exchange rate fluctuations is essentially supply and demand. If one country’s currency is in high demand in another country, its [exchange rate](#) will increase.

But many other economic, societal and geopolitical factors can also affect exchange rates. Examples are inflation rates, unemployment rates, changes in gross domestic product (GDP), levels of governmental stability, natural disasters and wars.

Currencies can also be traded, analogous to stock or commodity trading. Trading activity can impact value, as can intentional manipulation by governments or central banks.

How Do Exchange Rates Impact International Business?

Consider someone making a foreign investment in Mexico. If the value of the U.S. dollar decreases compared to the Mexican peso, the value of that foreign investment will increase (and vice versa). Thus, investors in foreign markets must keep a close eye on fluctuations in exchange rates.

The same holds true for the financial operations and investments of multinational companies on a much larger, more complex scale. For example, if a U.S. company sells a product in an international market at a set price and USD increases in value, that set sale price in foreign currency is worth less in USD. This decrease lowers the profit margin for sales in that market.

Similarly, a U.S. company might contract with a factory in Mexico to manufacture a product at a set cost in MXN. If the value of the Mexican peso increases compared to USD, but the manufacturing cost in MXN stays the same, the manufacturing cost for the U.S. company (represented in USD) will increase.

These are simple examples. Multinational companies profit and incur expenses from international operations and trade in complex and layered ways. Supply chain and logistics, manufacturing,

customer service, sales, taxes and legal fees are a few of the many areas that involve cost and revenue. Fluctuations in exchange rates can directly impact the relative value of expense or income in all areas of international business operations.

Given all of this, international business leaders constantly monitor exchange rates and consider the many factors that influence currency fluctuation. Whether internationally sourcing materials, contracting out production or expanding to new markets, management must assess and mitigate the risk involved in doing business in fluid markets.

Fluctuations in exchange rates have wide-reaching impacts on international firms. Therefore, understanding exchange rate determinants and the financial risk inherent to fluctuating international markets is essential for global business management.

Discussion Questions:

1. What is a Currency Exchange Rate?
2. What Factors Influence Exchange Rate Fluctuations?
3. How Do Exchange Rates Impact International Business?