The Effect of Exchange Rates onTrade Balances

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This paper empirically investigates whether exchange rates affect a country's trade balance. When they are highly volatile this affects a country's difference between payments paid for exports and payments received for imports, which reflects the trade balance. When this happens there is instability in the country's economic system whose ramifications go beyond its borders. This can cause a currency crisis, which is a situation in which the value of a currency becomes unstable, making it difficult for the currency to be used as a reliable medium of exchange. The International Monetary Fund is established to reduce these effects. 188 countries contribute to support its function. The findings in this paper should help us further understand the importance of this.

In the market for Foreign Exchange we see that there is a negative relationship between net exports, or trade balance and the real exchange rate. When you have a low real exchange rate, domestic goods are less expensive relative to foreign goods, which causes an increase in our net exports. The dependent variable will be trade balance or net exports. This will be influenced by the key independent variable, exchange rates, or the value of one currency against another. The data I have gathered is the real exchange rates and imports and exports from 1960 to 2014 of 16 European countries. This data came from www.worldbank.org using World Developer Indicators. Through use of this data we find a causal relationship between exchange rates and trade balances.

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