

## **ECONOMIC EFFECTS OF EXCHANGE RATE CHANGES IN THE GLOBALIZATION PROCESS**

### **KÜRESELLEŞME SÜRECİNDE DÖVİZ KURU DEĞİŞMELERİNİN EKONOMİK ETKİLERİ**

**Dr. Çağdaş CENGİZ**

Dokuz Eylül University, İzmir/Türkiye

**Dr. Ahmet Nazmi ÜSTE**

Dokuz Eylül University, İzmir/Türkiye



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#### **ABSTRACT**

With the collapse of the fixed, yet adjustable international regime determined by the Bretton Woods System, an improvement has been observed in commercial and capital operations and this has caused exchange rates, which are the most critical variable of these operations, to become even more significant. Globalization and its driving force, financial liberalization, have put capital operations and speculative variables into the focus of the factors affecting exchange rates. Analysis of the relationship between exchange rates and other variables reveals a mutual, multi-dimensional and cumulative interaction process. This interaction process, which has become more fragile and more complicated with the disappearance of capital controls and spreading of flexible rate systems, determines the value of exchange rates and their economic effects. Thus, in parallel with the variety of factors leading to changes in exchange rates, which are in continuous interaction with global, regional and national variables and which are the basic tools used in a national economy's relationships with the outer world, the multi-dimensional effects of exchange rates on other economic variables come out through various channels. In this respect, the destabilizing and complicating effects of current exchange rates on economy have been analyzed in this research, taking into consideration the transforming nature of the globalizing real and financial economic processes.

**Key Words:** Globalization, International Economy, Financial Liberalization, Exchange Rate

#### **ÖZ**

Bretton Woods Sistemi'nin belirlediği sabit fakat ayarlanabilir nitelikteki uluslararası rejimin çöküşü ve küreselleşmenin de etkisiyle ticarete ve sermaye hareketlerinde kaydedilen artış, bu faaliyetlerin en kritik değişkeni olan döviz kurlarının daha da önem kazanmasına yol açmıştır. Küreselleşme ve onun itici gücü olan finansal liberalizasyon, sermaye hareketlerini ve spekülasyon nitelikteki değişkenleri döviz kurlarını etkileyen faktörlerin ağırlık merkezi haline getirmiştir. Döviz kurları ve diğer değişkenler arasındaki ilişki incelendiğinde, tek yönlü değil çift yönlü, çok boyutlu ve birikimli bir etkileşim sürecinin geçerli olduğu görülmektedir. Sermaye kontrollerinin ortadan kalkması ve bununla birlikte esnek kur sistemlerinin yaygınlaşmasıyla birlikte daha hassas ve daha karmaşık bir hal alan bu etkileşim süreci, döviz kurlarının değerini ve ekonomik etkilerini belirlemektedir. Bu doğrultuda, küresel, bölgesel ve ulusal boyutlu birçok değişkenle sürekli etkileşim halinde olan ve bir ulusal ekonominin dış dünya ile ilişkilerinin başlıca aracı niteliğindeki döviz kurlarında değişmelere yol açan faktörlerin çeşitliliğine paralel olarak döviz kuru değişmelerinin diğer ekonomik değişkenler üzerindeki etkileri de çeşitli kanallarla yoluyla gerçekleşmekte ve çok boyutlu bir nitelik arz etmektedir. Bu bağlamda bu çalışmada, günümüzde döviz kurlarının ekonomi üzerinde daha istikrarsız ve karmaşık hale gelen etkileri, küreselleşen reel ve finansal ekonomik süreçlerin dönüştürücü niteliği dikkate alınarak analiz edilmiştir.

**Anahtar Kelimeler:** Küreselleşme, Uluslararası Ekonomi, Finansal Liberalizasyon, Döviz Kuru

## 1. INTRODUCTION

In the historical turning point starting from the collapse of the Bretton Woods System and reaching to the end of the 20th century, the globalization process supported by the haphazard growth observed in information and communication technologies has reshaped the modern world and societies and also played a transforming role on economic operations. World-wide economic decisions and politics have largely got under the effect and control of multi-national companies and the decision makers of the global capital such as the IMF, WB and the WTO, where the USA plays a dominant and determining role (Cengiz, 2018: 251). While playing this role, the USA has made the major contribution to this evolution and has considerably attained the main goal of transforming the world into a new order. Furthermore, the military force of the USA<sup>1</sup> has been imposed as an apron shield to the non-Soviet regions of the world (Kissinger, 2014: 394), even with a high hand. It is also theoretically expected that a hegemonic power always sets a target to extend its influence gradually from its near abroad to the ends of the globe (Dedeoğlu, 2008: 79-80). As an outgrowth of all these developments, a globalizing economic and socio-political structure comes into prominence. It is impossible to claim that the globalization has influence only over the states and big companies. It also imposes values and applies a unique pressure on the rights and attitudes, as spreading like an all-pervading web (Harari, 2018: 15).

On the other hand, with the change of global trade patterns due to the ever-increasing effect of the rising market economies, the substantial rise in the trading of world goods and services and with the driving force of capital flows, a number of structural transformations have come out in production and factor markets and increased the pace and the determining role of globalization. Global economy has reached a distinctive and more competitive point. The changing regional and sectorial composition of international trade flows have changed the role of exchange rates with regards to both the countries and economic unions and the international economy, as well (Mauro et al., 2008: 5-53). Thus, the economic system and politics options that fit the transnational practices have come to the forefront with economic globalization. Economic globalization can be characterised by the emergence and the rapid growth of the global capitalist economy which ignores the national borders and the economic self-sufficiency (Viotti and Kauppi, 2014). Along with the financial liberalization, which is the main element of economic globalization, financial relations have begun to take shape with the effect of stock variables (capital flows) rather than flow variables (commercial flows). This effect, which conditioned the preference of flexible systems in determining the exchange rates, has been reflected on exchange operations as more frequent changes and more uncertainty. As a result, exchange rates and exchange rate policies have become increasingly important.

Policies, which have transformed with the technological innovations decreasing the costs of transportation and communication, have applied pressure for the elimination of artificial barriers. This has caused globalization to become clear along with strong effects on the integration of labor, capital and product markets, on the liberalization of ideas and information flow and finally, on the structure of economy together with all its variables (Stiglitz and Greenwald, 2003: 176). The overall trend, starting with the first impressions of this transformation process and surviving until today, has become evident with the increased flexibility of exchange rates. This is mainly due to financial liberalization. Today, economies have become more open to and unprotected against the international financial capital (Ingham, 2004: 194).

In order to be able to evaluate the effects of exchange rates on other variables within this current conjuncture, it is necessary to elaborate the interaction between exchange rates and these variables first. As seen in Figure 1, exchange rates are affected by highly complex dynamics. Indeed, developments in global and/or bilateral economic and political relations between the countries are reflected on the national dimension and there, they interact with national economic, political and socio-cultural processes. Depending on these highly complex interaction processes, the value of exchange rates and their economic effects are determined.

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<sup>1</sup> See Mann (2013) regarding the relation between capitalism and militarism.

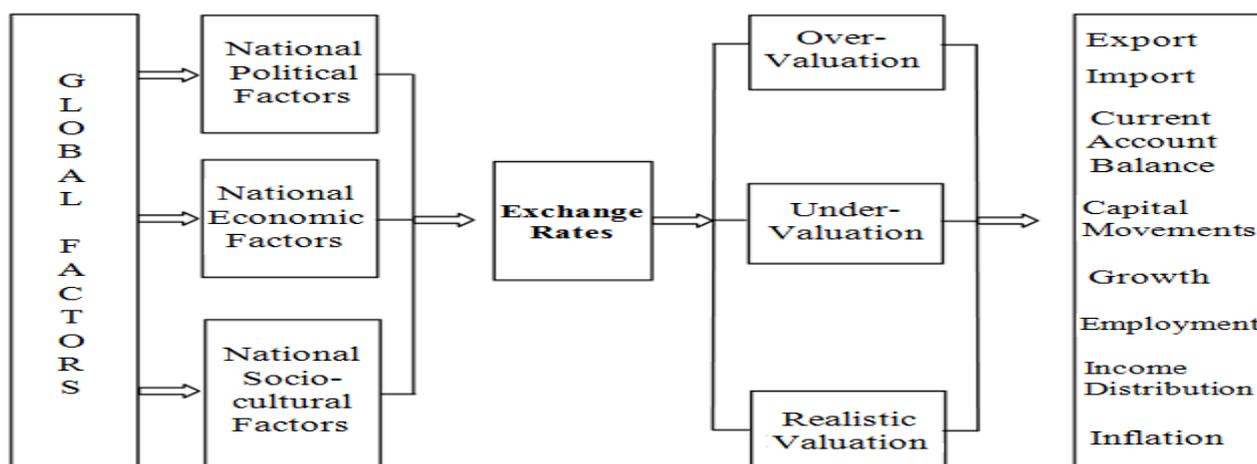


Figure 1: Interaction systematics between exchange rates and other variables

Source: Cengiz, 2018: 47.

Within the framework of the purchasing power parity, the value of exchange rates may be appraised as realistic, or they may be over-valued or under-valued. These levels of appraisal are primarily influential on foreign trade, in other words, on import, export and current account balance. Capital movements are involved in the process as a variable both affecting and getting affected by the value of exchange rates. Developments in foreign trade, current account balance and capital movements will inevitably affect the economic growth of the country and economic growth will affect employment and income distribution. The level of this interaction will depend on the country's primary production technique, that is, whether the country primarily uses the labor-intensive or the capital-intensive technique. Certainly, this means that the level of these interactions may vary depending on the development level of the country.

On the other hand, the country's inflation rate from this process, hence the nominal interest rates will also be affected by this process. Inflation, especially interest rates, and the developments to come out in these variables, will accelerate the process again. Because the driving force of global capital movements are the interest rates, to put it more precisely, inter-country differences of interest rates. Therefore, the effect imposed by exchange rates on economic variables, may cause these variables to feed their internal dynamics.

When assessing the interaction between exchange rates and other variables, it should be remembered that there is not a one-way but a two-way cumulative interaction process. In other words, the exchange rate is not a variable that either affects or gets affected but a variable that affects and gets affected at the same time. Therefore, while the significance of exchange rates has increased in today's conditions, it has become necessary for economic policy makers to evaluate this significance more carefully.

## 2. FOREIGN TRADE AS A MAIN DETERMINANT

With the end of the fixed but adjustable exchange rate system that lasted for about thirty years within the framework of the Bretton Woods System, where a relative stability was dominant in exchange rates, the changes and uncertainties of exchange rates have increased and the effects of exchange rates on foreign trade have become a subject to a greater number of researches (Auboin and Ruta, 2011: 3-18). So, regardless of the source factor (official interventions, external shock etc.), the change and uncertainty in the mutual values of currencies have been observed to be primarily affecting the foreign trade and to have substantial reflections on general economic performance. Therefore, the effect of exchange rate changes on the foreign trade performances of economies has emerged as a key element (Nicita, 2013).

Historical experience suggests that exchange rate movements have significant effects on export and import volumes both in developed countries and in emerging market economies, and in developing countries (IMF, 2015: 105). According to the standard foreign trade model which claims that foreign trade dynamics are determined by domestic and foreign demand/income conditions primarily through relative prices and the real exchange rate based on the assumption that the goods subject to exports and imports are perfect substitutes of each other, real depreciation of a national currency (depreciation against foreign currency) provides an international competitive advantage to exporting sectors in the country, leading to an increase in exports/decrease in imports and in the long run, causing production to head towards the exporting sectors that are advantageous in international competition. Thus, with the assumption that the Marshall-Lerner condition is met and that the exporting sectors are more productive, the change of production compound by

the loss in real value has a positive impact on economic growth in the long run. Indeed, policies for undervalued exchange, also defined as competitive exchange rate, have become determinant in the positive growth and the current accounts balance.

However, the Marshall-Lerner condition frequently does not apply in practice. Globalization in international trade and production has led to the development of different areas of specialization in countries' foreign trade structures and production processes. Consequently, certain processes leading to the final product are organized in different countries instead of the completion of all product processes in a single country. As a result, the ratio of intra-industry trade in international trade can increase, a country can make import in order to produce the product it will export, and import-export chain, up to the creation of the final product, can be realized in different countries. This process, which creates global supply chains, increases dependence of exports and production on imports and affects the real exchange rate flexibilities of foreign trade components. The process, which, on the one hand, increases the dependence of business cycles and growth dynamics of countries on external global growth and foreign trade conditions, facilitates, on the other hand, the import dependence of production and export due to the utilization of imported inputs in the production of export products. Thus, the dynamics of foreign trade reduce the flexibility of real exchange, i.e. the Marshall-Lerner condition is not achieved, for example, when a national currency gains value, importation grows as well, in other words, imported input dependence becomes influential in the effect of exchange rate changes on economy (Özmen, 2014: 8-12).

Especially with the exchange rate regulations that have become increasingly flexible since 1973, many macroeconomic fluctuations, especially the changes in the exchange rates, have gained a high level of uncertainty and volatility. Globalization tendencies accelerated by financial capital, which is one of the main factors feeding the fluctuations in exchange rates and uncertainty, have created a fragile network of economic relations which is highly dependent on external events and which has become more complicated and multi-dimensional due to the effects of technological advancements. Thus, while the external foreign trade items ensuring the external balance take the real sector, as well as the financial markets, under their influence, the nature of the change in exchange rates has an adverse effect on macro-economic variables in proportion with the level of its destabilizing uncertainty and volatility and this may even lead to crises (Gerni et al., 2013: 412).

### 3. GROWTH AND EMPLOYMENT

One of the most important elements contributing to the total production and competitiveness of an economy is the export volume indicating the foreign exchange sales of the goods produced in that country. Therefore, exchange rate changes have a significant effect on an economy's total production amounts of goods and services. The value of a country's currency is generally inversely proportional to the net exports of that country's economy. The standard external trade model assumes that, devaluation has a healing effect on the foreign trade balance. According to Machlup, the reduction in the physical volume of imports as opposed to the physical volume of exports in an economy indicates the achievement of the depreciation target in real exchange rate (Machlup, 1956: 421). In this target, there is a stimulating effect on economic growth in addition to progress in foreign trade balance. Despite this suggestion which is particularly true in terms of the economies of developing countries, different findings may emerge for developed economies. This distinction indicates the fact that the effect of exchange rate on growth has a meaning beyond the macro-economic balance (Rodrik, 2008: 365-366).

In order for the real exchange rate, that is, the rate meeting the relative price difference between the commercial goods and non-commercial goods to have a positive effect on production and economic growth, the Marshall-Lerner condition shall be respectively valid according to the trade channel suggested by the Mundell-Fleming model (which means that, the sum of absolute values of real exchange rate flexibilities of exports and imports is greater than one) and the production increase in other sectors shall exceed the narrowing in other sectors. As long as the Marshall-Lerner condition is provided, the decrease in the real exchange rate (depreciation of the national currency) will facilitate exports and shift the focus of total demand from imported goods to domestic goods, leading to a positive effect on foreign trade balance. Accordingly, while it is theoretically expected that the depreciation of the real exchange rate will shift financial sources to the more productive foreign trade products, and therefore affect growth in a positive way, factors such as the degree of openness, relative weight of exporting sectors and the domestic (export independent) input amount in production, play a key role for the creation of such effect on economy (Özmen, 2014: 4).

On the other hand, in some circumstances, depreciation of the real exchange (depreciation of the national currency), can cause economic recession especially considering the economies of developing countries. According to this, production and growth can be adversely affected by demand-side (inflationary effect, income distribution effect, real income reduction effect etc.) and supply-side (import input costs, nominal wage increases etc.) channels. Therefore, the net effect of the depreciation or devaluation of the real exchange rate on production and growth can produce different results under different circumstances. Globalization of production in parallel with the financial globalization and the development different specialization fields play an important role in this. Such that, a country can make import in order to produce the product it will export, and import-export chain, up to the creation of the final product, can be realized in different countries. As a result, dependence of exports and production on imports is increased and the real exchange rate flexibilities of foreign trade components are decreased. The depreciation of the real exchange rate under these circumstances can lead to economic recession (Özmen, 2014: 4).

Global funding conditions can, in a manner that is relatively independent from the country's own macro-dynamics, lead to appreciation of such country's currency through capital inflows or depreciation through capital outflows and to economic recession. In these cases, global liquidity conditions and capital movements also become key determinants of the relationships between the real exchange rate and economic growth. Thus, considering the effect of the financial channel as well as the trade channel, foreign indebtedness of the basic sectors of an economy, revenues of which are mostly on national currency, may lead to a negative account balance and finally to economic recession. The effects of real exchange rate declines on the production levels particularly in Latin American countries with high dollarization, have provided examples to this. Similarly, it is observed that, the potential positive effect of real exchange rate declines on employment may not occur due to the high proportion of debt dollarization. Thus, real exchange rate changes, sectors with different product capability/complexity or intensity of technology can have different effects on foreign trade and production levels. Real exchange rate declines can increase the rate of sustainable economic growth, by increasing the net export and production in the sectors that are subject to international trade or in technology-intensive sectors (Karadam, 2014: 199-210).

As already stated, the free fluctuation of the exchange rates brings certain costs as well as the benefits and the substantial fluctuations in nominal and real exchange rates can disrupt the re-distribution of resources. Indeed, economies have become more open with the liberalization of the exchange rates and international trade and many countries have begun to face more problems concerning the balance of payments. The success of preferred exchange rate systems and policies has become dependent on effect created on factor markets, as well as the economic balance. For example, an under-valued national currency can increase the competitiveness of national companies in the international market and thus, can increase exports, while reducing imports. However, high outward-orientedness facilitates dependence to foreign inputs used in national production. Under these conditions, devaluation causes an increase in the costs of the economic units and eliminates the expected benefits from the under-valued exchange rate (low-valued national currency). The net effect of changes in exchange rates is determined in this context, and an economy's or a sector's degree of openness to external effects becomes an important factor (Filiztekin, 2005: 2). Thus, in open economies, the effect of changes in the real exchange rates on domestic and foreign demand inevitably has significant effects on employment and income levels, too (Balaylar, 2011: 139).

The effect of changes in real exchange rates on employment and income distribution is realized through various channels. These are; the macro-economic channel that determines the economic activity and employment level in the short term; the development channel that determines economic growth and thus the pace of creation of new jobs; the labor intensity in economic processes and the labor intensity channel that determines the ability to create employment at an activity level (Frenkel and Ros, 2006: 632) and the outward-orientation channels of economy (labor cost of export products, imported input prices and import penetration channel), which are determinant in terms of the exchange rate (Balaylar, 2011: 139-143). Thus, the effect of exchange rate on employment and income distribution does not come out directly, but with the transition to prices, trade, competition and investment through these channels. For example, in the case of appreciation of the national currency, the decline in the prices of imported goods reduces foreign good demands of domestic consumers and reduces the demand for domestic goods and the shrinking domestic demand may lead to a reduction in the level of production and hence the employment capacity. This effect, which results in an increase in the unemployment rate, can also have disruptive effects on income level and unfair income distribution. Thus, the shrinking experienced in the exporting sectors can result in shrinkage at the total level of economy (Ayhan, 2016: 76-77).

The effect of changes in foreign exchange rates is felt more intensely in sectors that are more exposed to international competition, in other words, in sectors that are more open to foreign trade. In addition, while open and low-tech industry-based economies are more affected by the movements in the exchange rates, it is a natural result that open economies that carry out high-tech production, are more isolated from the negative effects of exchange rates. For example, when the circumstances in which a country participates in economic and monetary union are taken into consideration, such country becomes more open to external factors and international competition and the competitiveness of all sectors comes to the forefront as the key determining factor (Alexandre et al., 2009: 4). This can have significant effects on the labor market as well as employment and income distribution conditions. Increased imports or increased competition between imported and domestic goods can also have significant effects, in favor of the labor force, on employer-employee relations, working conditions and wage agreements/regulations. Therefore, it is inevitable that wages will be influenced by competition and the labor force conditions of the trade partner countries (Bilgin, 2004: 83). The ultimate effect of these processes triggered by the competitive pressure can become the source for practices involving regulations against the labor force, such as privatization, deregulation and flexibilization.

#### **4. TRIPLE INTERACTION: EXCHANGE RATE, INFLATION AND INTEREST RATE**

Inflation is not only a national but also an international phenomenon. The growth observed in world trade and capital flows along with globalization, the spread of multinational corporations and the international financial system's disruptive effect on the efficiency of the policies developed by national economies, the international nature of inflation has become more evident. This reality requires that international factors as well as national factors contributing to the price movements in a country are taken into consideration. The first notable factor in the transition of inflationary effects from one economy to another is the balance of payments. During the collapse of the Bretton Woods System, dollar's outflow, which occurred at unexpected sizes due to the deficits of the balance of payments, was proven to have an inflationary exportation quality. Apart from the channel of the balance of payments, the price effects of the internationally traded goods and services and the effects of increases in external demand are also factors that indicate the international nature of inflation. As a matter of fact, developing countries import inflation, especially through the prices of internationally traded goods (Ergun, 1987: 35). Exchange rates have a key role in the formation of these factors.

Apart from the channel of the balance of payments, the effect of the exchange rate on inflation can be realized, as stated above, through the internationally traded final goods and services and intermediate import goods and through their effects on inflationary expectations. In this context, the inflationary effects of exchange rate fluctuations realized within any exchange rate system framework, including, particularly, the exchange rate regulations basically aimed at inflation, have potentially significant consequences. This effect of exchange rate changes on domestic prices, in other words, the effect of foreign exchange rate, reveals out the relationship between the exchange rate and import and export prices, and the determining effect of the exchange rate on the inflation and interest rates comes to the forefront, especially in recently developing countries and in emerging economies (Ho and McCauley, 2003: 4-5).

As long as there is a difference in inflation among the countries, the exchange rates will also change to compensate for these differences. If the exchange rates do not change, then the real value of the currency of the country with the higher inflation will increase and the competitiveness of the country in the international market will weaken. In other words, an over-valued national currency leads to a decline in exports and an increase in imports, i.e., disrupts the current account balance.

The relationship between exchange rate changes and inflation indicates not a one-sided effect, but rather a two-way interaction, and the process becomes more complicated and multi-dimensional with the involvement of expectations in these interactions. For example, while devaluation is realized in order to remove the negative effect of inflation on the external balance calculations, it causes an increase in input prices and wages, thus, in production costs and can be a source of inflation itself. Moreover, the external deficit is a pressure on prices, as it allows a country to absorb more than it produces. The foreign trade deficit which gets reduced through devaluation can also lead to repressed inflation, as the possibility of such absorption is eliminated. Thus, as a result of the devaluation, the positive effect that is observed in the beginning of the external account of a country disappears and it may further get deteriorated with the effect of inflation. The process can turn into a vicious cycle requiring re-devaluation. Thus, inflation and devaluation can become chronic through reciprocal feeding, and the external balance problem can become

even more serious with the incorporations of a continuous inflation and devaluation expectation (Çağlar, 2003: 122-126).

As the relationship between the interest rate and the exchange rate is set out based on the Generalized Fisher Effect, i.e. based on the fact that the difference in nominal interest rates on two different national currencies (International Fisher's Impact) is equal to the difference in expected inflation rates of the countries. Thus, inflation rates among the countries, nominal interest rates and exchange rates among the currencies of these countries become more evident. For example, a country with a high rate of inflation has high interest rates and the exchange rates are expected to rise to that extent (Seyidoğlu, 2003: 355-358). Thus the value of a national currency is defined in three forms as; i) the interest rate, ii) the exchange rate of the national currency against the foreign currencies, and iii) the inverse of the inflation rate, and the balance in the money market is realized at the point where these three definitions are consistent. An inconsistency between these definitions determining the value of money causes the loss of balance in the money market, and this imbalance affects the real economy (Yeldan, 2017). This harmonious movement of the exchange rate, inflation and interest rates and the continuity of the balance among them are significant in terms of ensuring economic stability. Such that, any relative change in one of these variables disrupts the relative balance relationships between the internal and external balances of economy and have an adverse effect on overall economic structure. When the balance among these three pricing mechanisms is kept at low level, this brings the macro-economic performance of the country to a greater level, based on the circumstances. On the other hand, when it is kept at high level, there may be negative effects on economic growth and distribution of resources. In summary, a change that will be observed in one of these three variables, conditions a triple harmony and the interaction that will lead to certain detectable economic targets for ensuring economic growth and welfare (Sever and Mızırak, 2007: 279-280).

## 5. PROMINENCE OF INTERNATIONAL CAPITAL MOVEMENTS

International capital movements tend towards politically stable and economically dynamic countries. A country possessing these qualities on political and economic terms is expected to have a stable currency, as well. When the stability of a country's currency differs from other currencies in a positive manner, there emerges an attraction effect toward that country for international capital investments. On the other hand, a country with an instable currency with low value provides a risky and irrational option for international investors. In short, there is a direct relationship between the changes in the value of a national currency, that is, the changes in the exchange rate and capital movements.

International capital movements are classified in two categories as the foreign direct investment and the foreign portfolio investment. Between these two types, foreign investors choose the one that fits their structure and plan the most, in order to deploy their capital and make a profit (Galeza and Chan, 2015: 34-35). Foreign direct investments refer to the real investments realized by private or public entities in the form of international investors, on an asset or entity in another country in order to obtain a long-term benefit. Foreign portfolio investments, on the other hand, refer to the investments realized by foreign investors on stocks, bonds, other money market instruments and financial derivatives in order to obtain short term speculative financial profit (UNCTAD, 1999: 4).

The effect of exchange rates on foreign direct investments and the decisions on these investments may vary depending on the rate of imported inputs used by direct investor companies and on the quality of the exporters. Exchange rates also play an important role in investment and profit transfers. As the fluctuations and uncertainty of the exchange rates will indicate an unstable environment, they pose a risk for the direct investments aimed at a long-term and stable organization (Batmaz and Tekeli, 2009: 23).

As an indicator of competitiveness, exchange rate affects foreign direct investments through income and cost. For example, the increase in exchange rates could facilitate the use of national inputs in the production operations of export-oriented investors and allow such investor to increase the amount of his exports and profits. In this case, which poses an income effect, the increase of exchange rates has a positive effect on foreign direct investments. However, when the exchange rate increases in circumstances where imported inputs are used in the production of export-oriented investor and where there is a high dependence on imported inputs, there may be a reduction in export activities and profit of the investor. In this case, which poses a cost effect, the increase of exchange rates has a negative effect on foreign direct investments. Thus, the net effect of the changes in foreign exchange rates on foreign direct investments is shaped by the balance between income and cost effects (Yapraklı, 2006: 29).

The current position of financial liberalization, which is the main indicator of globalization, has become clear with the transnational mobility of capital flows aimed at achieving the highest real income through interest and currency arbitrage, in other words, maximizing profit and with the volume they have in the global economy. This process emphasizes the effect of international capital flows on national economies and the crises experienced, considering the role of multi-national companies and the volume of financial flows surpassing the real flows. Incorporation of the developments in information and communication technologies into the financial liberalization process has led to a growing share of capital flows, also referred to as “hot money flows”, and has helped them play a determining role particularly on developing economies. Excessive capital inflows in form of portfolio investment to developing countries offering higher profit opportunities and to neighbor economies, allow the national currency of countries to gain value against foreign currencies in a way that does not represent real production, causing exports to become more expensive, which may result in an increase in import dependence of such countries’ economies, due to weakened competitiveness of exporting sectors and cheapened imports. In this case, the rapidly growing foreign trade deficits disrupt the current account of countries, but there appears no actual payment problem as long as capital inflows continue. Thus capital inflows, which are basically based on the contradictory arbitrage phenomenon mainly arising from the contradictions between the interest and exchange rates, are conditioned by high interest rates and over-valued exchange rates, which, in turn, further deteriorates the internal and external balances of economies, similar to the process we have already mentioned in the vicious cycle of devaluation and inflation. While serving the increase of production potential in certain conditions, such economic growth indicates a foreign-dependent and artificial nature and may collapse when the hot money tends towards safe harbors at the point where the delicate balances between interest and exchange rates are deteriorated (İnsel and Sungur, 2003: 1-6).

## **6. OTHER VARIOUS EFFECTS: ECONOMIC, SOCIAL AND POLITICAL RISKS**

In addition to the effects of exchange rates on macro-economic variables, there may be a number of other effects on different layers of the economic, social and political atmosphere. In addition to the official units that shape their decisions based on the exchange rates and exchange rate estimations, international companies, particularly including the multinational companies, micro-level economic decision-making units, commercial enterprises and consumers are affected by changes in exchange rates and take into account currency fluctuations and uncertainty when shaping their future expectations. The instability and uncertainty reflected on exchange rates from various political risks and economic instability expectations may lead domestic and foreign financial assets to tend toward safer harbors. The reflection of these processes on currencies may cause the current instability and uncertainty to deepen together with the political and socioeconomic dimensions.

Changes in exchange rates and uncertainty highlight the risk factor that must be taken into account by economic units. Currency risk, which represents the changes that can occur in companies’ payables, receivables, net cash flows and therefore market values due to the unforeseen changes in foreign exchange rates, is an important determinant for all economic units, particularly including the banks and foreign trade companies. Companies dealing with imports and exports who want to be protected from exchange rate risk try to predict the national currency equivalents of the transactions they make with foreign currency and the expected changes in the future, and to act accordingly. Therefore, changes in exchange rates affect the decisions to be taken by such companies and the quality of the organization they are planning. In particular, large businesses may tend to borrow from overseas markets as well as from domestic markets in order to meet their short-term external financing needs. Assuming that international financial markets operate effectively where the International Fisher Effect is valid, the market to which the business is indebted has no significance. On the other hand, in cases where parity conditions deteriorate, costs can change depending on the market indebted to. However, possible changes in exchange rates not only affect foreign trade companies and companies dealing with external financial activities, but also those dealing with domestic market oriented activities. As mentioned earlier, exchange rate changes are closely related to production costs and sales prices as a factor affecting overall price movements. Financial decision-makers of such business need to determine the effect of exchange rate changes and take decisions in a way that will allow these effects to optimize net cash flows and the market value. Foreign exchange risk can be managed through the exchange-based contracts and preservative treatments and the benefits and costs of risk undertaking (Seyidoğlu, 2001: 210-213). Therefore exchange rate changes with factors directly affecting the micro-level decision units inevitably generate results that affect the overall economy.

The effect of foreign exchange rates and estimations on short-term financing and investment decisions concerns not only private businesses, but also public institutions. Indeed, central banks and other public institutions can get indebted to international money markets at certain periods or can deposit their fund surplus in these markets. Similarly, Governments can get indebted to or make investment to foreign markets. Current or expected changes in exchange rates also affect the determination of the type of currency to be preferred for such indebtedment or investment transactions and its magnitude in terms of such currency (Seyidođlu, 2001: 152-153). For example, considering that a foreign trade imbalance will be determined by the sum of investments, savings and the budget balance, based on the absorption approach, countries with low-saving levels and budget deficit may need to tend toward domestic and foreign indebtedment in order to be able to finance the public. If foreign indebtedment is preferred, the structure of such indebtedment (magnitude, duration, interest rate etc.) plays an important role and determining role of the exchange rate between the indebted currency and the national currency, becomes more evident. Thus, a rise in exchange rates can have a budget deficit magnifying effect, as well as its effects on growth and inflation, by causing the interest rates of indebtedment to increase in national currency. Especially countries with low domestic savings which have a balance of payments deficit, thus, underdeveloped sources of financing, need to resort to this method frequently.

While indebtedment in liberalization conditions where exchange rates are more variable and more uncertain, may seem to be useful in the short term in providing growth and the suppression of inflation, it makes national economies become more open to and fragile against crises in the long term (Çađlar, 2003: 151). In this respect, while financing of economic activities through foreign indebtedment allows for the postponement of the internal and external imbalances in economy, it cannot prevent that they appear in the future in an accumulated and more substantial manner, leading to deep economic and subsequently social and political crises.

## 7. CONCLUSION

The interaction and balancing mechanism between the exchange rate and economic variables emphasizes the way exchange rates are determined and the ways they affect economy. Exchange rate is one of the most important variables that establishes and influences the connection of a national economy with the outside world. The effect and development of exchange rates and exchange rate policies have become more important along with the empowered capital movements and the globalization process which has gained pace after 1990s. In many countries, mistakes and crises appearing in this issue have had serious economic, social and political consequences. Therefore, research on exchange rates has become important.

Exchange rate, which is a basic variable for the internal and external economic balance, has a key role in terms of economic stability and is affected by rather complicated processes and dynamics. These dynamics are fed by the global and/or bilateral economic and political developments between the countries, which have reflections on the national platform. Analysis of the relationship between exchange rates and other variables reveals a two-way (not one-way), multi-dimensional and cumulative interaction process. This interaction process, which has become more fragile and more complicated with the disappearance of capital controls, determines the value of the exchange rates and their economic effects.

Within the framework of the purchasing power parity, the value of exchange rates may be appraised as realistic, or they may be over-valued or under-valued. These levels of appreciation primarily affect the foreign trade and current account balance and capital movements get incorporated in the process as a variable affecting and getting affected by the value of foreign exchange rates. Developments in foreign trade, current account balance and capital movements affect economic growth, and economic growth affects employment and income distribution. The content of this interaction may change depending on the country's level of development. Developments that will arise in inflation and interest rates are likely to re-accelerate this interaction process.

In conclusion, financial liberalization has come out to be the most determining phenomenon in the period after the collapse of the international system defined by the Bretton Woods Regime. Globalization and its driving force, financial liberalization, have emphasized capital movements and speculative variables among the factors affecting exchange rates. The mutual, multi-dimensional and cumulative interaction process between the exchange rates and other variables has become more fragile and more complicated with the disappearance of capital controls and spreading of flexible exchange rate systems. In this study, it was tried to analyze the reflections of this interaction on the main economic variables taking into account the transformative nature of globalizing real and financial economic processes. In summary, the negative effects

of exchange rate fluctuations on economic stability have increased in the conditions of financial liberalization where exchange rates are more unstable and uncertain. So, as the effect of the globalization process on economic developments and variables has become evident, the scope of effects created by the system and policy preferences about exchange rates has widened, as well, and these effects have become more significant. Moreover, it would not be an integrative way to evaluate this process just as an economic interaction, where the same effect is easily observed in social and political dimensions as well.

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