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A large, dark, monochromatic portrait of Adam Smith, a Scottish philosopher, economist, and sociologist, serving as the background for the top half of the cover. He is depicted from the chest up, wearing a wig and an ornate 18th-century coat.

How Currency Shapes Global Trade:

Exchange Rates, Investment, & Stability

PAUL MUELLER

The American Institute for Economic Research educates people on the value of personal freedom, free enterprise, property rights, limited government, and sound money. AIER's ongoing scientific research demonstrates the importance of these principles in advancing peace, prosperity, and human progress.

250 Division Street
PO Box 1000
Great Barrington, MA 01230
Telephone: 1-888-528-1216
Fax: 1-413-528-0103
info@aier.org

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Global trade can be a hot-button topic. Whether we have free or fair trade and issues like national security, jobs, and economic development are recurring touchpoints of debate. But what about the value of the US dollar? Tariffs figure prominently in trade policy, but the relationship between international trade and currency values has been less discussed. Currencies play a crucial role in every transaction.

The relative obscurity of how trade policy and currency interact may partially be due to the complexity of that relationship. The value of currency influences the exchange of goods, services, and capital. Policymakers and businesses should understand this dynamic because it directly impacts economic stability and competitiveness. Contrary to export-focused easy money advocates who want the value of their currency to decline to make exports more attractive, a sound money strategy of keeping the value of one's currency strong and stable offers the best conditions for long-term trade arrangements. Indeed, free trade and free markets promote sound money, as countries compete for business and investment.

Real Trade and Currency

At its core, trade involves exchanging goods for goods. This is true of international trade too - French wine for American corn, German cars for American computers. As David Ricardo famously argued, nations benefit from specializing in and trading goods they can produce at a comparative advantage. Having a comparative advantage means being the lowest opportunity cost producer of some good (you give up the least to produce it).

Currencies facilitate transactions, and the value of currency directly impacts the terms of exchange. This trade principle extends to capital goods like tractors and semiconductor manufacturing equipment, and to international financial exchanges, such as German companies investing in US stocks or real estate. When we consider capital investments, the exchange picture broadens. Yes, Germans could trade cars for American computers, but they could also trade cars for American stocks and bonds.

Currencies are a good that can be bought and sold like any other good. We often think of the price of the currency in terms of another currency (e.g. how many dollars does it cost to purchase a euro?), but currencies can also be priced in terms of goods (e.g. how many euros can I “buy” with an iPhone X?). This means that currency values (prices) are subject to the forces of supply and demand in the market.

Unlike most other goods, fiat currency is virtually costless to produce and is issued exclusively by central banks. This is why a tremendous amount of

energy (and ink) has gone into studying central banks and how they can cause inflation or hyperinflation by rapidly increasing the supply of a currency and thereby driving down its price (purchasing power) in terms of everything else.

But if we assume the central bank exercises restraint and maintains a stable supply of currency, the demand side drives most of the day-to-day volatility of currencies. Currency traders and policymakers want to know: Who wants the currency? Why do they want the currency? How much do they want the currency?

Ever since the creation of the Bretton Woods system in 1944, the relative strength or value of the US dollar has rested on high international demand for dollars as a means of settling transactions. This has made the dollar the global “reserve currency.” Rather than using their domestic currencies, France and Saudi Arabia, for example, might simply buy and sell goods (in this case, oil) with dollars. This creates a complicated global system of exchange as countries run surpluses and deficits of dollars.

Saudi Arabia trades tremendous quantities of oil for dollars (garnering the label “petrodollars”). They use some of those dollars (a relatively small fraction) to buy goods and services from the US and other countries. They use the rest of their dollars in capital investment – hence their enormous sovereign wealth fund – the Public Investment Fund – with assets worth nearly a trillion dollars.

Large importers of oil, like China, need billions of dollars to purchase oil from countries like Saudi Arabia. This partially explains why China runs such a large current account surplus with the US. Rather than buying billions of dollars of US goods, China needs those dollars to buy oil. The easiest way to acquire those dollars is to sell huge quantities of goods to the US.

In recent years, there has been some talk of de-dollarization by BRICS countries – Brazil, Russia, India, China, and South Africa, and many other potential bloc members. The challenge they face, however, is that Saudi Arabia has little interest in acquiring billions of Chinese yuan or Russian rubles, because these currencies are less widely accepted. Saudis would need to convert those currencies into dollars if they wanted to invest in US companies or real estate. This would require finding others with a strong interest in acquiring yuan or rubles.

When trading goods denominated in different currencies, however, the smooth functioning of this trade depends on stable and predictable currency exchange rates. Wild swings in the value of currencies can create wind-

falls or big losses for companies that sell their goods for foreign currency. Exchange rates (the price of one currency in terms of another) operate under two primary systems: fixed exchange rates and flexible exchange rates.

These two systems have tradeoffs. Both have facilitated periods of rapid global economic growth and international trade. The first big explosion in global trade occurred under the classical gold standard from roughly 1871-1913. This period saw long-term stable exchange rates, as most major currencies were valued in terms of a set quantity of gold. The second major period of globalization, following the collapse of the Bretton Woods system, occurred under flexible exchange rates.

Exchange Rates: Flexible vs. Fixed

A country can fix its exchange rate by pegging its currency to another currency. Under this arrangement, the central bank agrees to redeem domestic currency for a fixed amount of foreign currency and redeem foreign currency for a fixed amount of domestic currency. To do this, central banks must carefully manage reserves of both currencies. As they have limited control over their foreign currency holdings, most central bank policy focuses on managing the issuance and supply of their domestic currency, as well as its policy interest rate.

Some countries (Ecuador, El Salvador, and Panama, among others) have “dollarized,” meaning they have abandoned their own domestic currency in favor of using the dollar. Dollarization eliminates the need for an exchange rate. The low cost of digital stablecoins denominated in dollars will make it easier for more countries to dollarize in the future.

Robert Mundell, a Nobel laureate in economics, pointed out that the choice of exchange rate regime can have far-reaching consequences for a country’s economy. He emphasized the trade-offs between stability and flexibility in exchange rate management and wrote about optimal currency blocs. Under a flexible regime, the exchange rate fluctuates. Under a fixed regime, prices and interest rates fluctuate.

On the other hand, large swings in capital investment can create currency crises for smaller countries, especially those that rely heavily on one or two major industries. The Baht crisis in Thailand in 1997, which spread to the rest of Asia, and the Peso crisis in 1994-1995 are two prime examples of instability and crisis that can develop under a flexible exchange standard. These countries had fixed exchange rates and massive inflows of capital that their central banks attempted to sterilize, instead of allowing prices and interest rates to adjust.

In effect, central banks tried to subsidize general foreign investment by not adjusting interest rates and domestic currency supply to match capital inflows. Major imbalances grew, creating various asset bubbles, until foreign investors became worried about the financial strength and prospects of the country and began rapidly withdrawing their capital. Central banks in Thailand, Mexico, and elsewhere had insufficient resources to maintain their official exchange rate in the face of rapid withdrawals.

With flexible exchange rates, currency values fluctuate based on market forces, such as trade flows and capital movements. This system, advocated by another Nobel laureate, Milton Friedman, dominates today. Friedman argued that flexible exchange rates embody a true free market in currencies. He believed that allowing market forces to determine currency values would lead to more efficient allocation of resources and greater economic stability. In theory, central banks will need to intervene far less in foreign exchange markets under a flexible exchange rate regime than if they are maintaining a fixed exchange rate.

A major question under any exchange rate regime is what mechanism(s) correct trade imbalances. An old idea called the price-specie flow mechanism, initially elaborated by David Hume in the eighteenth century, best illustrates how trade imbalances can self-correct. Although this model was originally developed to describe trade under an international gold standard where national currencies were tied to a fixed quantity of gold, its principles generally apply in a world of fiat currencies, too.

Price-Specie Flow Mechanism

Imagine that two countries only traded with each other for goods and services. Country A imported \$100 billion more in goods than Country B (so it ran a \$100 billion trade deficit). That means at the end of the trading period, A would have \$100 billion more in goods and services on net, and B would have \$100 billion more of A's currency.

The logical thing for country B to do with all that extra currency from country A would be to buy more goods from A. But suppose the merchants and businesses in B were not interested in increasing their purchases from A. A's currency doesn't do them much good. But A's gold is worth something to them. They will want to redeem their holdings of A's currency for gold, which they can spend domestically in country B.

Redeeming A's currency for gold has several effects, all of which apply pressure to reverse the \$100 billion trade imbalance between A and B. First, as people in country B redeem their excess currency from A for gold, gold will

flow from country A to country B. As A's gold reserves shrink, the quantity of A's currency must also shrink because it is tied to (redeemable for) gold.

If the supply of A's currency didn't contract, people would increasingly redeem the overly abundant currency for the increasingly scarce (and therefore increasingly valuable) gold. This phenomenon has occurred repeatedly throughout history, nearly always resulting in a country like A suspending the gold redeemability of its currency (i.e. leaving the gold standard).

But if Country A reduces the quantity of its currency to prevent such an imbalance between currency and gold, it will see its prices fall, both in terms of its domestic currency and in terms of gold. Goods in A become cheaper. The reverse occurs in B. As more gold flows into B, their domestic currency should expand, which causes prices in B to rise.

With falling prices in A and rising prices in B, firms and individuals will, if allowed, shift their purchases. They will reduce their imports from B and increase the buying or making of goods in A. Similarly, firms and individuals in B will shift towards buying more (cheaper) goods from A and buying or making fewer goods domestically.

A's exports to B consequently increase, while A's imports from B decrease, thereby reversing the trade imbalance from the previous period. Like a rubber band that provides ever more resistance as you stretch it, the greater the trade imbalance, the greater the flows of gold, and the greater the change in prices to reverse the imbalance.

This basic logic holds true as we introduce more countries. Those that export more (on net) than they import will see gold flow into their country causing their domestic prices to rise. Net importing countries, on the other hand, will see gold flow out of their countries causing their domestic prices to fall. Nor does adding capital investment and capital flows change the underlying logic of the price-specie flow mechanism.

It does, however, add an additional channel of reversal: interest rates. It is beyond this Explainer's scope to outline how gold outflows in a fractional reserve banking system cause interest rates to rise. What matters is that they do rise. Similarly, countries with large inflows of gold should see their interest rates fall. These interest rates are yet another price signal for investment to reverse trade imbalances.

Trade imbalances that lead to currency accumulation should affect the value of that currency (its purchasing power) as well as domestic prices and interest rates, in a way that returns the system to balance. But central bankers

can introduce friction into the system and dampen the price signals created by trade imbalances.

During World War I, most countries suspended gold redeemability for their currency so that they were free to artificially create more currency and credit to fund their war efforts. The result, by the end of the war, was significant inflation. Some countries, like France, devalued their currencies in terms of gold. Other countries, like England, returned to their old valuation. But they had created too much currency, which led to significant redemptions for gold and subsequent gold outflows.

Rather than allowing gold inflows to lower interest rates, putting upward pressure on domestic prices, central bankers in France and the US “sterilized” gold inflows in the 1920s by storing them, rather than using them.

This is not something that a competitive profit-seeking bank would have done. But central bankers governing in the “public interest” chose to do so. As a result, massive trade and capital imbalances built up after World War I, contributing to the collapse of the international monetary system and the global depression of the 1930s.

The Current Account and Capital Account

Many people misunderstand trade imbalances because they do not know the difference between the current account and the capital account. For decades, the “trade deficit” has been touted as a serious problem, or at least a symptom of dysfunction, in the US economy. But people rarely talk about how the trade “deficit” only exists in the current account which tracks the trade of goods and services between countries. The capital account, which tracks investment flows between countries, rarely receives a mention.

Yet these accounts mirror each other. A trade deficit in the current account implies a capital account surplus, and vice versa. Even though the US has experienced current account deficits for decades, it has also experienced corresponding capital account surpluses for decades. These accounts must balance, except for tiny discrepancies arising from foreigners increasing or decreasing their overall holdings of dollars.

The United States has run a trade deficit in its current account for over thirty years. Every year Americans buy more goods and services from foreigners than foreigners buy from Americans. In the 1990s, this deficit was \$100 billion to \$300 billion a year. In the 2000s, the deficit continued to rise, reaching a remarkable \$1.1 trillion in 2024.

What's also remarkable (and relatively unnoticed) is that the US has run a capital account surplus in the same amounts - including the eye-popping \$1.1 trillion surplus in 2024. These numbers simply mean that foreigners want to invest in US assets - including manufacturing - much more than Americans want to invest in foreign markets.

It also means Americans are more interested in buying goods and services from the rest of the world than foreigners are interested in buying US goods. A strong international demand for dollars in general also makes foreigners more eager to sell to Americans and less eager to buy from them. None of this means that Americans are somehow becoming poorer or more indebted to foreigners.

Conclusion

Understanding the nuances of the relationship between international trade and currency can help us avoid pushing inconsistent or counterproductive policies. For example, we cannot increase the capital account surplus and reduce the current account deficit simultaneously. Whether using fixed or flexible exchange rates, or the historical lens of the gold standard, currency values play a vital role in shaping trade flows and investment decisions.

Just as it would be foolhardy for government officials and agencies to attempt to manipulate the terms of domestic trade between different kinds of goods, federal policy attempting to control the terms of trade between countries, whether through tariffs or manipulation of the money supply and interest rates, will lead to distortions and problems.

Abundant energy, low taxes, and regulatory reforms can increase real output in the US, resulting in lower prices and, conversely, a stronger dollar. This stronger dollar will appreciate against other currencies. Suppose, for example, that US output doubles without an increase in the supply of dollars. These lower prices will make US goods more attractive to foreign buyers, but buyers will need dollars to buy US goods.

As foreign demand for dollars rises, the price (value) of the dollar will also rise. This means it will take more euros or yen to buy a dollar, and that dollar buys more goods than before the productivity boom. So, yes, it may take more euros or yen or pesos to buy a dollar than in the past, but each dollar will go much further, which means that the domestic price of US goods will fall. The presumed cost savings leading to the productivity and output growth in the United States will offset the seeming pricing disadvantages of trading in a relatively more "expensive" country.

A stronger dollar also allows Americans to buy more goods and services than before, as the dollar buys more foreign currency. This benefits Americans as consumers. But when the US economy produces goods in increasingly efficient ways without creating more dollars, trade and exports can remain strong and support robust domestic economic growth.

Constrained monetary policy on the part of central banks is crucial for developing efficient trade between nations. Central banks should prioritize maintaining the purchasing power of their currencies over time. This benefits consumers, savers, and a nation's global trade position. While concerns exist about the impact of a strong currency on exports, these are often offset by cheaper imports. More importantly, a stable currency creates confidence and encourages long-term investment, which in turn fosters long-term prosperity.



250 Division Street | PO Box 1000
Great Barrington, MA 01230-1000
Telephone: 1-888-528-1216 | Fax: 1-413-528-0103
Press and other media outlets contact
888-528-1216
press@aier.org