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FOREIGN EXCHANGE RATES: FACTORS THAT DETERMINE AND INFLUENCE

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Abstract

The price of one currency relative to another is also known as the exchange rate. The exchange rate system that would apply to a country's currency is determined by that legislature. A currency, for example, can be floating, pegged (stable), or blended. Government has the authority to set exchange rate limitations and controls. A country's currency might be strong or weak. Financial stability, increased purchasing power, and worldwide trade are all benefits of the foreign exchange rate. The supply and demand of the currency are controlled by market forces, which cause this rate to vary. The degree of nominal and relative inflation, as well as the level of income, has a significant impact on the determination of exchange rates. Government actions, international situations, natural disasters, or any other unforeseen event can all have an impact on exchange rates. Aside from that, the interaction of the components might result in a variety of thinking that affects the market. With the use of appropriate instances, this study attempts to uncover several factors.

Keywords: *inflation, economy, currency and foreign exchange rate*

INTRODUCTION

An exchange rate is usually expressed as an abbreviation for the national currency it signifies. The US dollar, for example, is denoted by the abbreviation USD, while the euro is denoted by the abbreviation EUR. EUR/USD is the currency pair that represents the dollar and the euro. It's USD/JPY, or dollar to yen, in the case of the Japanese yen. The concept of foreign exchange risk is predicated on the presumption that exchange rate changes are unpredictable and are influenced by how efficient foreign exchange markets are. Foreign exchange rate volatility is a significant risk element for businesses, particularly those that conduct worldwide business. Since the end of the Bretton Woods fixed exchange rate regime in 1971, exchange rate swings have been a major source of concern for investors, analysts, managers, and shareholders. This process was initiated by a floating rate system, in which currency rates are regulated by money supply and demand.

A spot rate, often known as cash value, is the current market value of an exchange rate. A currency value may also have a prospective value, which is determined by predictions for the currency's rise or decline in relation to its current price.The real effective exchange rate is used to exchange foreign currencies. When a rate rises, it is referred to as appreciation, and when it falls, it is referred to as depreciation. Variations in supply and demand drive the foreign exchange rate throughout time. A variety of variables contribute to this shift in demand and supply. These are known as foreign exchange rate affecting variables. A higher exchange rate increases the cost of exports while lowering the cost of imports for the economy. However, a fall in the exchange rate makes exporting more reasonable while making products more expensive. Any nation aspires for a higher exchange rate because it improves the country's financial situation. It's also expected because a higher exchange rate assists any country's current account surplus stay lower.

LITERATURE REVIEW

(Kihara & Muturi, 2016) investigate the effect of external foreign exchange risk management techniques on the financial performance of commercial banks in Kenya. The analysis was conducted for 43 banks out of 39 banks registered in Kenya on the basis of data availability. Pearson correlation test and regression analysis were used. The study revealed that there were significant influences of financial derivatives on the performance of commercial banks in Kenya. There was a positive effect of options, swaps, forward on the performance of commercial banks in Kenya.

(Meghana, 2012) examined corporate hedging for foreign exchange risk in India. The main aim of this paper was to assess the various alternatives available to the Indian corporate for hedging financial risks. This paper studies the choice of the instruments adopted by firms to stem their foreign exchange exposures. The data was collected form company's annual reports for the period of 2006-2007. Finally, Result revealed that forwards and options were preferred as short term hedging instruments whereas swaps was preferred as long term

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hedging instruments. The study suggests that highly use of forward contracts by Indian firms highlights absence of rupee futures exchange in India.

(Rabeya Akter, 2021) examined the factors that influence foreign exchange rate. This study is based on how different types of factors that influence exchange rate. The study noticed that foreign exchange rate provides financial stability and enhance purchasing power. Due to market force this rate generally fluctuate which control the demand and supply of currency. So for that this study tried to find out the factors that determine and affect the foreign exchange rate.

(Simakova & Jana, 2017) investigate the impact of exchange rate movements on firm value in visegrad countries. The main objective of this paper was to evaluate the impact of exchange rates on the value of companies listed on the stock exchanges in the visegrad countries. This paper applied Jorion's model and panel data regression for the sample period 2002-2016.The study conclude that there were a negative relationship between exchange rate and value of stock companies.

FACTORS INFLUENCING FOREIGN EXCHANGE RATES

Exchange rates are determined by a variety of things. Many of these issues are linked to the two countries' trading relationship. Keep in mind that exchange rates are relative and are expressed as a comparison of two countries' currencies. Some of the most important factors that influence the exchange rate between two countries are listed below. Consider that these components are not listed in any particular sequence; the relative relevance of these factors, like several other areas of economics, is widely contested. Below is a list of all the factors that influence foreign exchange rate.

$e = \int (\Delta INF, \Delta INT, \Delta INC, \Delta GC, \Delta EXP, \Delta CAD, \Delta PD, \Delta TT)$

Here,

e = denotes the percentage change in the spot foreign exchange rate.

INF=Change in the inflation disparity between the home nation and the foreign country

INT=Change in the interest rate disparity between the home nation and the foreign country.

NC= Change in the income disparity between the home nation and the overseas country.

GC= Change in Government Controls.

EXP=Change in Future Exchange Rate Expectations

CAD= Current Account Deficit

PD = Public debt and Tax

TT = Terms of Trade

➢ INFLATION RATES

Currency exchange rates are affected by changes in market inflation. The value of a country's currency will appreciate if its inflation rate is lower than that of another. When inflation decreases, prices of goods and services rise at a moderate speed.Japan, Germany, and Switzerland had low inflation in the final part of the twentieth century, but the United States and Canada did not reach low inflation until much later. Countries with greater inflation generally saw their currencies depreciate against their economic ties' currencies. Higher interest rates are frequently associated with this.Let's say a company in the United States and a company in the United Kingdom both sell alternative items. If UK inflation rises but US inflation remains unchanged, UK demand for US goods will rise, as will UK demand for US currencies. Furthermore, demand for UK goods in the United States will fall, reducing the supply of US dollars. The supply curve will shift leftward due to reduced supply, while the demand curve will shift rightward due to higher demand. The new equilibrium rate will then be greater than the current rate.

➢ INTEREST RATES

Interest rates, inflation, and currency exchange rates are all intertwined. Central banks control inflation and exchange rates through managing interest rates, and changing interest rates affects inflation and currency values. Higher interest rates provide a better return to lenders in a given economy than in other countries. As a result, higher interest rates entice foreign capital and drive up the currency rate.Assume that the UK interest rate rises while the US rate remains unchanged. In this circumstance, investors in the United Kingdom are likely to cut their demand for dollars. UK rates are currently more appealing, and US institutions require fewer deposits. Because UK rates are now more appealing, US investors with extra cash will boost the amount of dollars available for sale in order to invest in the UK. The equilibrium exchange rate will fall due to the inward shift of dollar demand and the outward shift of dollar supply.

➢ INCOME LEVELS

The amount of import demand and the exchange rate are both influenced by one's income level. Assume that the UK's income level rises while the US's income level remains fixed. As a consequence of the increase in UK income and higher demand for US goods, the demand curve will shift upward. The supply schedule, on the other hand, is unlikely to change.As a result of this, the equilibrium exchange rate has risen.

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➢ **GOVERNMENT CONTROLS**

Variations inflation expectations have an impact on international trade, which effects currency demand and supply, and thus exchange rates. Let's say a company in the United States and a company in the United Kingdom both sell alternative items. If UK inflation goes up but US inflation remains unchanged, UK demand for US goods will rise, as will UK demand for US currencies. Furthermore, desire for UK goods in the United States will fall, reducing the supply of US dollars. The supply curve will shift leftward due to reduced supply, while the quantity demanded will shift rightward due to higher demand. The new equilibrium rate will then be greater than the current rate.

➢ **FUTURE EXCHANGE RATE EXPECTIONS**

The factor that determines the exchange rate is future exchange rate forecasts. Foreign exchange markets, as with all financial markets, respond to news that has the potential to have long-term consequences. The authorities can influence the exchange rate by increasing or decreasing it.Allow word to circulate in the United States that inflation will rise in the near future. It will cause traders to sell US dollars, resulting in a rise in supply. Demand, on the other hand, will have no bearing. As a result, supply will be reduced, resulting in a reduction in the exchange rate. However, if word of deflation in the United States spreads, traders will buy US dollars in order to buy all of the US dollars on the market, raising US dollar demand. The supply, on the other hand, will remain unchanged. The equilibrium exchange rate will rise as a result of this.

➢ **CURRENT ACCOUNT DEFICIT**

The current account is a country's trade balance with its trade agreements, representing all payments for goods, services, interest, and dividends made between countries. A current account deficit indicates that the country is spending more on foreign trade than it is earning, and that it is borrowing money from other countries to cover the gap.This extra demand for foreign currency lowers the home currency's exchange rate in exchange for foreign currency, resulting in foreigners paying less for domestic commodities.

➢ **PUBLIC DEBT AND TAX**

To pay for public initiatives and government subsidies, countries will participate in large-scale deficit financing. Whereas this activity boosts the economy at home, countries with huge public deficit spending are less appealing to foreign owners. A huge debt fosters inflation, and if inflation increases, the loan will be paid and eventually paid off with less expensive real dollars.Changes in tax rates cause money to flow in and out of the country.Tax cuts have a considerable expansionary influence on macroeconomic indicators, according to empirical research. Tax cuts for individuals and businesses boost production, development, employment, and demand.

➢ **TERMS OF TRADE**

The conditions of commerce are another key aspect that influences a country's exchange rate. When a country's exports exceed its imports, trade is considered to be positive. However, if the converse occurs, the situation is not beneficial. When export conditions improve, the country's goods are in high demand outside of the country, indicating higher currency demand. As a result, that nation's exports appreciate. (Madura, 2010).

CONCLUSION

Finally, it may be stated that exchange rates are influenced by a large number of factors. Inflation, interest rate differentials, inequalities in income level, government control, and changes in expectations are the five most essential elements. These influences shift demand and supply patterns, resulting in a new exchange rate in a new equilibrium state. However, other factors such as political stability, conditions of trade, market judgment, and so on, all have a role in influencing the demand for currency and the change in the foreign exchange rate.

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