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THE DEMAND AND SUPPLY FOR THE FOREIGN CURRENCY AND FACTORS AFFECTING THE EXCHANGE RATE

The demand for the foreign currency appears from the need to buy goods and services abroad. The demand for the currency of any country in the foreign exchange market indicates that there is a demand of foreigners for goods and services of this country. The level of demand for the currency depends on the price of the offered good. With the decline in prices of goods more buyers are willing and able to buy it.

Buyers who want to buy foreign goods, will need a currency of the selling country in exchange for local currency at the price prevailing in the market, that is at the exchange rate. The demand for currency of the seller of goods will depend on the price of foreign currency (the exchange rate). The supply of currency by the selling country appears, in its turn, due the necessity to buy the goods (i.e. the demand for the product) in the purchasing country of its products.

In market economy currency price fluctuates under the influence of supply and demand. If the exchange rate is too high, the currency supply exceeds demand, and price of the currency will decline. If the price is too low, demand will exceed supply, and the rate will increase. Due to these fluctuations it is composed the price equation of currency or the market price. The market price is the exchange rate at which the supply of currency in the foreign exchange market is equal to the demand for it.

Understanding of the exchange rates essence and types of their quotation allows you to compare the export price of the good to the price of the domestic market, and thereby find out how profitable is the sale of a particular product or service in a particular foreign market [1].

The reduction in prices of the national currency reduces prices of national products, which are denominated in foreign currency (the goods become cheaper for foreigners). This contributes to the growth of exports, which is becoming more competitive. At the same time, the price of foreign goods, which are denominated in local currency, rises and their imports decline. The rise in the exchange rate of national currency makes domestic goods more expensive, the prices of which are expressed in foreign currency (the goods become more expensive for foreigners). Their exports decline and become less competitive. At the same time, the price of foreign goods, which are expressed in national currency, reduces and imports rise.

The long-term fundamental factors, determining the exchange rate movements, are the processes in the area of national production and circulation. This, above all, the relative (relative to the world level) labor productivity and, respectively, production costs, the long-term growth rates of the GNP, the place and role in world trade and the export of capital. The relatively faster productivity growth in one country (the relative increase in labor productivity) in the long run leads to higher relative purchasing power of national currencies in relation to the goods and therefore to the increase of the exchange rate of the country. This makes it possible to predict the long-term development of the exchange rates.

The higher production costs and prices in the country (less than labor productivity) compared to the world ones, the more imports rise in comparison with exports, leading to a depreciation of the currency, and vice versa. This factor is called "purchasing power parity" (PPP). Currency on world markets compared to international value of certain amount of goods and services, presented by one or another currency unit. There is a relationship of two currencies, in which a certain amount of money can be exchanged for the «market basket» of goods and services with same composition and volume in both countries in the process of the international and global economic relations. This will be the purchasing power parity, that is, a level of the exchange rate of two currencies that equalizes the purchasing power of each of them all other things being equal.

The growth of national income of the country, leading to increased demand for imported goods, generates demand for the currency of the importing country and the tendency to the depreciation of the national currency. And the rise in exports associated with the growth of national income in the other country, generates an upward tendency of the national currency of the exporting country.

In the field of management of the factors determining the long-term trend of movement of the exchange rate, there are: the inflation, its rate compared with the rate of depreciation of major currencies. The higher rates of national inflation, other things being equal, lead to a decrease of the exchange rate of the country in relation to countries with relatively low rates of depreciation of money. In the case of inflation, the exchange rate change is purely nominal, and is opposed to the real exchange rate in the case of the relative change in labor productivity. If in the first case it is possible to influence the exchange rate towards its improvement by using monetary policy (the reduction of emission of money, the increase of lending rates, etc.), then in the second case – by means, directed on the increase of labor productivity to a level that ensures competitiveness in the world market.

One of the factors that determines the exchange rate movements, is the relative level of real interest rates, that is, the nominal interest rate adjusted for the inflation rate. The relative level of real interest rates regulates the flow of capital between countries. The increase in interest rates makes the country attractive for. investment funds, thereby increasing the supply of foreign currency and the demand for the national currency. Low interest rates limit or cause the capital outflows, in consequences of which the demand for foreign currency increases. Accordingly, the exchange rate has the same behavior. In the first case, it has a tendency to increase, and in the second – to decrease. Thus, a stronger inflation and lower real interest rates lead to a depreciation of the currency.

The balance of payments of the country also affects the exchange rate. Generally, the passive balance worsens the situation in the world market of a particular currency, as the demand for foreign currency exceeds its offer, and the active balance – improves, as the supply of foreign currency exceeds the demand for it.

Short-term fluctuations in exchange rates depend on the psychological factor – market «expectations» of participants of the foreign exchange market (guesses of bankers and dealers concerning the prospects of the dynamics of the rate of a particular currency, currencies interventions, etc.), generating all kinds of speculation in the currency markets, including speculative capital flows. Expectation of a further decrease (increase) of the exchange rate creates longing to get free (or buy) from this currency, which leads to an even greater decrease (increase) of the exchange rate.

Currency intervention, that is the intervention of central banks and treasuries into the currency operations, conducted to both improve and reduce the exchange rate of their country or foreign currency [2]. If it is set the objective to increase the exchange rate of the national currency, the banks and the treasuries recourse to massive sales of foreign currency and purchase of the national currency. If the country is interested in reducing the rate of its currency, the opposite process happens - massive buying of the foreign currency and selling of the national currency. The currency intervention can only temporarily affect the movement of exchange rates. The extent of its effectiveness depends on the amount of finance of ad hoc currency funds.

The decline in the national currency promotes the dumping of goods [3]. However, currency dumping brings additional revenue only when the external depreciation of currency, i.e. reduction of its exchange rate, is ahead of internal depreciation, i.e. decline in the purchasing power of money in the country. Only in this case, the product selling for the same (or lower) price in a foreign currency, the exporter swaps this currency to more of his own national currency as a result of the drop of the latest one. This allows him to buy more domestic equipment, raw materials and labor for the production expansion.

In the conclusion it should be noted that forecasting of the exchange rate is performed by banks, firms and TNCs. The aim of forecasting is to improve the insurance of exchange risks and to make solutions more effective in the field of international financial management. Forecasting enables to make the correct choice of the currency of price and the currency of payment in foreign trade contracts; currencies of both international credit and payment; the currency in which the account of corporations is maintained in the bank; the currency in which the foreign investments of companies are denominated or the foreign assets of the bank.

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