FACTORS INFLUENCING FOREIGN EXCHANGE:

Foreign exchange market is a very sensitive market so are the foreign exchange rates. A variety of factors have their direct influence on foreign exchange market and the exchange rates which are determined in these markets.
As the exchange rates are determined through demand and supply forces in the foreign exchange market so any factor that brings about a change in either demand or supply will ultimately influence the exchange market.
Following are some of the important factors which have their direct influence of exchange rates.

1. Changes in Price Levels:
Price level of a country plays a significant role in determining the trends of exchange rate. Take the case of 2 countries Pakistan and England. If the price level in Pakistan rises due to inflation. This means that our goods have now become more expensive. This feet the demand for our goods in the international market and will result in the reduction of demand for our exports. Consequently our exports will now demand fewer rupees to exchange for pounds to purchase Pakistan goods. So the demand curve will shift leftwards and rupee will depreciate. This discussion can be summarized as follows: When price level of country A rises relatively to that of country B, the value of currency of country a fall relatively to that of country B.

2. Capital Movement:
Capital movements across borders of countries exert strong influences over exchange rates. In a country where capital is flying in at a high rate, the currency appreciates. On the other hand, the currency of the country from where the capital flies out, depreciates also if any country attracts investments from aboard then currency of the country will appreciate.

3. Speculations:
Uncertainty about future exchange rate induces people to speculate about them. This also influences exchange rates. If foreigners expect rupee to appreciate, they will rush to buy Pakistani assets, and goods that are denominated in rupees. This will increase the current demand for rupees and hence rupees will appreciate. One the other hand, if investors suspect that rupee is going to depreciate in future; they will not buy or invest in Pakistan assets. This will result in fall of demand of rupees and hence rupee will demand for the currency of this country is also high. If exports further increase, then the demand for the currency also increases which in turn leads to appreciation of currency. The converse happens when the domestic currency which finally leads to the

depreciation of currency.

4. Structural Changes:
Structural changes refer to the changes and improvement in the state of technology, innovations, inventions of new products and new ways of producing old products. All these advancements lead to the change in the pattern of comparative advantage. Innovations and advancements results in the production of new and improved products which attracts thousands of new customers. Thus the demand for such products increases both nationally and in the world market. This consequently leads to increase in exports and appreciation of in exports and appreciation of currency. On the other hand if, country does not attention towards such new inventions and innovations, it will lose its. Thus exports will.

5. Political Stability:
Political stability, sound infrastructure, security, certainty about future and these factors play significant role in the determination of exchange rate. If there is political stability in a country, returns are healthy, future is predictable, and then such country attracts investments from all over the world. Investors rush to invest there and capital flies in. All these factors lead to the appreciation of currency.
On the other hand, if there is political instability and weak infrastructure, then such country looses capital funds which eventually lead to depreciation of currency.

6. Exploration of Natural Reserves:
When a country explores more natural resources, it takes a further step toward self sufficiency and independence which means less reliance on other. This also affects exchange rates.
For instance assume that Pakistan fulfils 60% of its total petrol consumption demand from outside and only 40% is produced locally. Now if we are able to explore more and more of our natural resources and if we can have more oil wells here, this will reduce our demand for imported oil. Thus supply of our currency in the world market will be reduced causing appreciation of currency.

7. Influence of Bank Rates:
The banking operations and variations in the bank rates also influence exchange rates. If bank rate is high, borrowing will be expensive and funds from outside the country will flow in to earn high return. This will lead to the appreciation of currency converse happens when bank rates are low and borrowing is cheap.

8. Stock Exchange Influence:
Working and status of stock exchange markets also influence exchange rates. If is a country, there is an active capital market and active and healthy business of factor stock , shares, debentures is going on then funds will flow in to take advantage of these factor. This will produce good and favorable effects on exchange rate and it will

appreciate. On the other hand if business is sluggish and passive, then investments will not flow in and there will be depreciation of currency.

Conclusion:
These are the factors which normally affect exchange rates. In real world, the situation is not so simple. Besides these, many other apparently irrelevant factors can also produce serious effects on the exchange rate. Apart from this exchange rates are also regarded as an important indicator of economic activity and high fluctuations in these can produce serious effects on the working of the economy.

<u>Exchange Rate System:</u>
There is basically two type's f exchange rate system. Fixed exchange rate system and floating exchange rate system. These are explaining below:

FIXED EXCHANGE RATE SYSTEM:
Meaning & History:
Under the fixed exchange rate system, the exchange rate is fixed. But it is not absolutely fixed, rather fixation of rate means that it is only allowed to fluctuate between sum limits.
The fixed exchange rate system was adopted by majority of countries of world (except the communist bloc) after World War II. The decision was taken in the Breton woods, conference of 1944 and it was supported by international monetary fund.
The reason behind the Breton woods decision was that the world had witnessed the great depressions of 1930 s and the conference was actually called to devise policies to ensure steady running of world economy onwards. Among other decisions, the members decide to adopt fixed exchange rate system.

The working of system:
The system works on the basis that exchange will neither be allowed to fall below a particular level nor to rise above a limit. In other words, it will be kept in certain limits but free to move among them.

The system works as follows:
Suppose the rupee rate is fixed at 50 lira. Under IMF rules, the exchange rat4e may vary up to 1% of the fixed rate on either side so the allowed regime of movement in this case will be 49.95 to 50.05. However in practice much narrow limit are chosen by the central bank of the country and if the rate tends to crawl out of those limited is signal for the central bank to intervene.
First suppose that rupee is appreciated and rate rises to 50.02 lira. Central bank will now come in the scene. To discourage the rate from rising further, it will sell his own currency in the market and purchases liras. This will put down pressure on the rate. Conversely if the rupee is depreciating the central bank will buy it is own currency to put upward pressure on it.

In both the cases, either by buying or selling, the central bank will try to iron out the fluctuation in exchange rate.

Important Note:
In the above example, rupees and liras are used for the sake of simplicity. In practice the rates are maintained against $ or £. These two currencies are said to be the world's trading and reserve currencies.

Advantages of Fixed Exchange Rate:
Following are the advantages of this system.
*. It ensures better control over the exchange rates.
*. It allows more powers to central bank so that it can exert considerable influence on BOP or other macro economic variables.
*. It provides the hedge against unnecessary depreciation of currency.
*. It eradicates the speculative business to a great extend.

Disadvantages of Fixed Exchange Rate:
Following are the disadvantages.
1. First of all it reduces the central bank liquidity. This is because central bank always has to hold huge gold and exchange reserves just for the buying and selling of home currency in home market. Due to this fact such reserves can't be used elsewhere. If majority of the countries are working on fixed exchange rate then not only the liquidity of central bank of all such countries are reduced but the international trade liquidity is also reduced.
2. The system does not give any method of changing the rate once fixed initially. The need to change the rate arises in response to fundamental disequilibrium in country's balance of payments. But no easy method of changing the basic rate is provided by this system. The only way out available is that of devaluation but that in itself could prove drastic in certain circumstances.