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EXCHANGE RATE - REGIMES AND POLICIES

ДЕВИЗНИ КУРС – РЕЖИМИ И ПОЛИТКЕ

Summary: *Exchange rate of one currency is the price of the currency expressed in units of other currency. It is formed by the interaction of supply and demand in the foreign exchange market. Given that the exchange rate has a direct impact on the competitiveness of a country in terms of features of its exports and imports, in its balance of payments, and indirectly the overall economic and social development, in addition to acting in market principles - supply and demand in the formation of the equilibrium exchange rate, exchange rate is subject to different, stronger or weaker, more or less, forms of intervention. In the search for the optimal exchange rate policy of the national currency, the monetary authorities are positioned between the two extremes - the complete abandonment of the exchange rate to the market laws of supply and demand, or fixing the exchange rate for any of the selected anchor currency.*

Key words: *The foreign exchange market, exchange rate, appreciation, depreciation, devaluation, revaluation, the theory of purchasing power parity, the law of equal price, interest rate parity, exchange rate regimes;*

JEL classification: *E42, E52, E58, O24*

Резиме: *Девизни курс једне валуте представља цијену те валуте изражену у јединицама друге валуте. Формира се у интеракцији понуде и потражње на девизном тржишту. Обзиром да промјене девизног курса имају директан утицај на конкурентност једне земље у смислу могућности њеног извоза и увоза, на њен платни биланс, а индиректно и укупан привредни и друштвени развој, поред дјеловања тржишних законитости – понуде и потражње у формирању равнотежног девизног курса, девизни курс је подложан различитим, јачим или слабијим, већим или мањим, облицима интервенција. У тражењу оптималне политике девизног курса националне валуте, монетарне власти се позиционирају између два екстрема – потпуног препуштања девизног курса дјеловању тржишних законитости понуде и потражње, или фиксирања девизног курса за неку од одабраних сидрених валута.*

Кључне ријечи: *Девизно тржиште; девизни курс; теорија паритета куповне моћи; паритет каматних стопа; режими девизног курса;*

ЈЕЛ класификација: *E42, E52, E58, O24*

1. INTRODUCTION

The possibility to compare the price of goods and services is the basic moving force of international trade – products and services whose price on the domestic market is relatively lower compared to the prices formed for those products and services on the comparing foreign market will be exported, and products whose price on the domestic market is higher than on the foreign market – will be imported. This is the reason why the exchange rate of the national currency is one of the crucial questions of the overall economic and social development of a country. Changing the exchange rate has the most direct impact on the competitiveness of a country in the international trading flows, and therefore on its balance of payments, and indirectly on its overall economic and social develoopment and the living standards of its citizens.

Nowadays, when the consequences of the world financial crisis caused by the real estate market crisis in the USA have not yet been cured, when the explosion of the debt crisis within the European monetary Union strongly shakes its foundations, when the political turbulence in the world,

especially in the countries of Northern Africa endanger the energetic and raw material markets, the countries request from their monetary authorities even more and more intensely to "create" a space for larger incentive of the domestic economies in sense of their better competitiveness on the international market. Starting from the fact that nowadays most of the member-states of the World Trade Organization are obliged to respect the policies of this organization – ensuring discrimination-free trade, transparency, i.e. predictability of trade policies and liberalization and eased access to markets, which includes a limitation of highest allowed customs rates and other customs and non-customs measures targeted to boost and induce the export of own products or services, the competitiveness is more frequently achieved through weakening of the national currency, which finally results in a type of cold currency war, in which the policy of the exchange rate plays a very significant role.

2. FOREIGN CURRENCY MARKET

The development of international trade implies the use of different national currencies. The price of one currency expressed through the value of another currency (Samjuelson and Nordhaus 2009, 604) represents the exchange rate of that currency in relation to the expressed currency. The exchange rate, depending on the offer and the demand, is formed on the foreign exchange market. The foreign exchange market is the market where foreign currencies (*foreign currencies*) (Bjelica et al. 2001, 377) are sold and purchased, and includes the trade with foreign exchange assets and bank deposits in foreign currencies (Šoškić and Živković 2011, 230).

In its nature, the foreign exchange market is not physically limited, but it exists everywhere where the exchange of currencies occurs (Bjelica et al. 2001, 377). It is organized as out-of-the-stock exchange market, where participants – most frequently banks, buy and sell foreign exchange assets and bank deposits denominated in different currencies, and they are ready at any time, depending on the instant size of the foreign exchange rate, to take a selling or buying position.

The size of trade in the foreign exchange market is huge, and the largest part of this trade is performed in the biggest financial centers such as London, New York, Tokio, Frankfurt, Zurich etc., therefore from practical reasons we often refer to a specific foreign exchange market personified by individual financial centers. We must emphasize that nowadays, with the modern information infrastructure which enables immediate transfer of information, the foreign exchange trading is part of a unique world market where "the sun never sets" (Krugman and Obstfeld 2009, 324). The size of the trade on foreign exchange markets – in total and per financial center – is best illustrated with the following data: in April 1989 the total value of global trade with foreign exchange currencies is almost 600 billion dollars per day, from which 184 billion dollars is in London, 115 billion dollars in the USA and 111 billion dollars in Tokyo. In April 2007, 18 years later, the global daily value rose to around 3,2 trillion dollars, out of which 1,36 trillion dollars in Great Britain, 664 billion in the USA and 238 billion in Japan (Krugman and Obstfeld 2009, 324).

The above data refer to the trade on organized foreign exchange markets, where individual transactions expressed in dollars, exceed amounts in millions, and the price of the currencies, or the exchange rates formed through these transactions, cannot be generalized and are different from the prices of the currencies traded on a retail level.

Generally speaking, on the foreign exchange market there are two types of transactions. In the first type, the exchange (trade) of item which is subject to transaction – foreign exchange assets or bank deposits in foreign currencies – is performed instantly, without delay, at the moment of concluding the transaction or the latest within the period defined with the speed of executing the warranty (payment order) for exchange of values. The other type of transaction is the exchange of values in future, on a specific date of exchanging values (*value date*) which is periodically different than the date of conclusion, but according to the exchange rate agreed at the time of conclusion. In relation to this, for prompt transactions this is a prompt foreign exchange rate (*spot*), while for the term transactions there is a term exchange rate. There is a high degree of correlation between the prompt and the term foreign exchange rates, and usually the term rates are higher[1] than the prompt rates, for the amount of the "term" provision.

[1] In practice sometimes the term sale is at a price lower than the prompt price. This is the case referred to as a "term discount".

The activity of buying and selling foreign currencies on the market, especially on the term foreign exchange market, also represents exposure to potential currency risks. The economic risk is the most important category of risks, which occurs as a result of the exchange rate change of the domestic currency in relation to the value of foreign exchange and inter-currency rates in near or far future. These changes of the domestic currency in relation to the value of foreign exchange and inter-currency rates in near or far future, cause change of the value of future income and expenses. Regardless of the fact that these changes can be considered as an opportunity or possibility to achieve profit, economic risk of currency is primarily considered as a source of a threat, i.e. a possibility for suffering a loss. This is the reason why the participants of the foreign exchange market undertake measure of risk management. There are two responses to the economic risk, caused by currency trading. The first one is protection from risk, so the loss can be put to a minimum extent. The other is accepting the risk, in order to make profit from it. In the first case we talk about hedging, and in the second – about speculation. (Bjelica et al. 2001, 380). Financial derivatives are used as hedging instruments – forwards, futures, options and swaps. In principal, eliminating the risks (the hedging) includes getting involved in a financial transaction which eliminates a long position on the basis on an additional short position, or eliminating a short position by an additional long one (Mishkin 2006, 309). Unlike the hedging operation whose target is to eliminate, or weaken the possible loss, the speculation is accepting the currency risk in order to gain profit (Bjelica et al. 2001, 380). Speculation is performed both on the prompt and on the term market, and the basic principles with estimated low currencies are – buy cheap, sell high, which means selling the currency and its future purchase at a price lower than the selling price, after the expected depreciation, or devaluation happens (of the currency which is subject to transaction); while with the estimated high currency – after the expected appreciation or revaluation of the currency happens.

As mentioned before, the development of international trade includes the use of various currencies whose exchange rate, depending on the demand and offer, is being formed on the foreign exchange market. In order for a transaction of buy-sell of a currency to happen efficiently, especially when it is a case of buy – sell of currencies of small countries with moderate participation on the international trading flows, in practice a "mediation currency" is frequently used. It is a currency mostly used in order to denominate international agreements signed by two parties located in the country emitting the mediation currency (Krugman and Obstfeld 2009, 325). Any world currency with a wide range of transactions can play the role of mediation currency, i.e. a currency with a significant role in the international financial flows. At the moment, the American dollar has a dominating role of mediation currency in the world. We can expect an increasing participation of the Euro especially if, through resetting the concepts of the European monetary Union in order to strengthen the federalism, the fiscal, monetary and political integration, and the appropriate legal protection of the Euro, the Union manages to find a way out of the crisis in which the Euro and the European Monetary Union are today.

3. FOREIGN EXCHANGE RATE

The economic transactions which follow the trade with goods and services within a country, or a currency region, are relatively simple. The price of goods or services subject to trade, is expressed and paid in the same currency. The problem occurs with international trade, which includes participants of different currency regions and use of different currencies. In order to perform the transaction (buy or sale) of goods or services between residents of different currency regions, the *Conditio sine qua non* is the pre - calculation of prices and the value expressed in the currency of one region into the price or value expressed in currency from another region. The price of one currency expressed in another currency is called foreign exchange rate (Krugman and Obstfeld 2009, 317), or the value of one currency in relation to another is called foreign exchange rate (Mishkin 2006, 435).

The value of the Foreign exchange rate of a foreign country can be expressed in the domestic currency in two ways: (a) as a price, or monetary amount of the domestic currency which needs to be paid for a unit (one or 100) of the foreign currency, or (b) as a price, or monetary amount of the foreign currency which needs to be paid for a unit (one or 100) of the domestic currency. The first manner is called direct notation (so called European convention), and the other is Indirect notation (so-called British convention).

Expressing the value of one currency in another (the foreign exchange rate,) enables the comparison between the price of goods and services produced in different countries. The changes in the exchange rate of one country's currency related to another country's currency are directly reflected on the competitiveness of goods and services, produced in that country. If we assume the existence of a balanced situation in the foreign exchange market after which a market imbalance occurs, we have two possible options: (a) the currency value of one country rises compared to another currency or appreciates, and (b) the currency value of one country decreases related to another currency, or depreciates.

What is the result and which are the consequences?

If the prices in the country whose exchange rate has changed, as well as the prices in the countries in relation to whose currency the rate has changed, are stable in the domicile currencies and are not changing, the results of the actions from the mentioned options for change of currency value are: (a) with the growth of currency value in a country compared to the currency value in other countries, the value of goods and services from that country will become more expensive for the amount of the relative growth of the exchange rate, or the currency value of this country compared to the others, and (b) with the decrease of currency value in a country compared to the currency value in other countries, the value of goods and services from that country will become cheaper for the amount of the relative decrease of the exchange rate, or the currency value of this country compared to the others. When the currency of a country appreciates (increases compared to another currency), the goods of this country abroad become more expensive, while the foreign goods in this country become cheaper (if prices are not changed in both countries). On the opposite, if the currency in a country depreciates, its goods become cheaper abroad, while foreign goods are more expensive in this country (Mishkin 2006, 438). In this case, especially on a short-term basis, the interests of the producers and the spenders, or of the economy and the population of the country whose currency appreciated or depreciated, are totally opposite. In case of appreciation of the domestic currency value, domestic goods become more expensive and less competitive on foreign markets, which makes the producers' interests hard to reach, while at the same time the competitiveness of imported goods and services rises, since they become cheaper (seen through the domestic currency), which in the consumers' best interest. In case of depreciation of the domestic currency, the situation is opposite from this one.

The fact is that the supply and demand for foreign currencies on the foreign exchange market, whether it is a prompt or term supply and demand, are moving the prices of the exchange rate to higher or lower, until reaching their balance. The balance between the supply of foreign currencies in one currency, and the demand for foreign currencies in the same currency defines its price, and the foreign exchange rate expressed in another currency.

We must emphasize that the foreign exchange rate is a very important factor in the country's monetary policy and as such, it cannot be left exclusively to the free influences of the market laws for supply and demand. This is the reason why there are always present some smaller or larger, direct or indirect, interventions of the monetary authorities, in order to keep the foreign exchange rate on a certain level, in accordance with the adopted policy. If the supply and demand for a certain foreign currency is approximately equal, the exchange rate is steady, and we can say that there is a balance on the market. Since many factors influence the supply and the demand, this balance is constantly endangered. This is the reason why the state frequently intervenes in order to defend the existing balance, or to establish a new one. These interventions can cause (*overvaluation*) and (*undervaluation*) of the domestic currency (Bjelica et al. 2001, 378).

The interventions of the monetary authorities can be on the market or normative– institutional. The market interventions can be direct – buying or selling foreign currencies in its own name and for its own account, or indirect – increase or decrease the supply of money on the domestic financial market, which indirectly influences the relation between the supply and demand on the foreign exchange market. The normative–institutional interventions are specific of a foreign exchange rate policy where the "balance" between the overvaluation and undervaluation is regulated through decisions of the monetary authorities. Establishing the "balance" by out-of-the-market measures, or normative–institutional measures of the monetary authorities is reached by devaluation–decrease of the rate value for the domestic currency in case of its overvaluation, or its revaluation – increase of the rate value for the domestic currency in case of its undervaluation.

3.1. Foreign exchange rate – theoretical basis

The basis for the theory of setting the exchange rate is reaching the balance on the foreign exchange market. During this …the rate is set on the basis on the interaction between the supply and the demand, same as with the prices on any other asset on the free market (Mishkin 2006, 439). In theoretical researches for defining the foreign exchange rate there are several models which can explain the manner of achieving a balanced foreign exchange rate in a long or short term.

One of the most important theories for setting the foreign exchange rate on a long term basis is the theory for Purchasing Power Parity *(Purchasing Power Parity – PPP*). This theory explains the changes of the Foreign exchange rate through the difference in the general level of prices, where the general level of prices includes individual prices of products and services which represent the basket of products and services of a country.

The PPP theory has two forms – (a) absolute, based on comparison between the general level of prices, and (b), relative, based on comparison between the changes in the level of prices, or the inflation in the countries between whose currencies the foreign exchange rate is being set.

In the absolute form of the PPP Theory, the exchange rate between the currencies of the two countries is equal in relation to the level of prices in those two countries, expressed in the prices of the reference basket of products (Krugman and Obstfeld 2009, 412). Basically, the theory starts from the law of equal prices, which means that if the two countries produce identical goods and if the transportation costs are small as well as the trade barriers, then the price of those goods should be the same everywhere in the world, regardless of where these goods have been produced (Mishkin 2006, 439), and the principles of the equal price law are applied to the total national level of prices, and not to an individual price.

Since the results from researching the reliability of the PPP theory have not given a significant empiric support to this theory, nor to the law of unique price, the absolute PPP theory has evolved into a relative PPP theory, which foresees that the percentage change of the foreign exchange rates are equal to the differences between the national rates of inflation (Krugman and Obstfeld 2009, 412). The relative PPP theory does not compare the general level of prices between the countries, but only the relative changes in the prices, expressed through inflation rates, or growth of the general level of prices. The growth of prices, or the inflation on the domestic market compared to the foreign one, without changed foreign exchange rate, will lead to non-competitiveness of those country's products, and they will have to be imported. On a long term basis, this situation is unsustainable, because with an increased import and decreased export, this country will fall into imbalance of payment. This imposes the use of a new, balanced exchange rate, where the balance will be established after a correction on the exchange rate of this country, with the growth index of prices for representative products, or the inflation in relation to the compared foreign one.

The monetary approach of defining the level of exchange rates merges the PPP Theory with the supply and demand for money, and it means that the exchange rate which represents the price of one country's currency price, expressed in another country's units…. on a long-term basis is completely defined by the relative supply and demand for money in these two countries. The changes in interest rates and in the production levels influence the exchange rate only through their influence on the demand for money (Krugman and Obstfeld 2009, 378).

Basic factors which influence the exchange rate on a long-term basis are: (a) relative level of prices; (b) trading barriers; (c) preferring domestic goods over foreign; and (d) productivity. For all these factors in general, if the factor increases the demand for domestic goods, the domestic currency will be appreciated, and if the factor decreases the relative demand for domestic goods, then the domestic currency will be depreciated (Mishkin 2006, 442).

When defining the exchange rate on a short-term basis, modern approaches (unlike older ones which emphasized the importance of export and import flows) emphasize the expected income of the denominated assets represented through the bank deposits denominated in the comparing currency. If the factors of risk and solvency do not have great influence on the demand for assets denominated in foreign currency, then the participants on the foreign exchange market always prefer to keep the assets which have the highest expected income (Krugman and Obstfeld 2009, 343). Making the decision to keep a deposit on the basis of assets denominated in one or another foreign currency includes a comparison of the expected income from the two compared currency forms which further includes their expression in one and the same currency, or a comparing expression. The amount of income from

the deposits depends on the interest rates and the expected changes in the exchange rate, or the expected appreciations and depreciations of compared currencies within the period of their possession. The short-term balance on the market is achieved through the realized parity of interest rates – which means that deposits kept in all currency must offer the same expected income rate, when incomes are measured in comparable expressions (Krugman and Obstfeld 2009, 344).

3.2. Foreign exchange rate – regimes and policies

When discussing the theoretic basics of the exchange rate, we start from the thesis that the foreign exchange market is completely free, and the exchange rates are formed as balance of the supply and demand. However, as mentioned before, the exchange rate is too important factor in the monetary policy to be left solely to the free actions of supply and demand. In practice, the exchange rate is also subject to various, stronger or weaker, bigger or smaller forms of interventions of the monetary authorities which, in search of an optimal policy of exchange rate for the national currency, are positioned between two extremes – to fix the rate to some of the chosen anchor currencies, or a total release of the exchange rate to the influences of market supply and demand. Between these two extremes, as a mix and compromise between the fixed and the fluctuating exchange rates, there are some average regimes, which are supposed to take into consideration the good sides of both policies – the advantage of a disciplined fixed exchange rate and the bigger influence of the market for the fluctuating exchange rate (Jovović 2011, 66).

When choosing an exchange rate regime, the monetary authorities face a dilemma of the impossible trinity of the three desired outcomes – the autonomy of running their own monetary policy, the benefits of free capital movement and a steady exchange rate. One of these three must be sacrificed. If one chooses a steady exchange rate and free capital movement, the autonomy in monetary policy must be sacrificed; if we choose the autonomous monetary policy and free movement of capital, then we must choose flexible exchange rate; if the choice is steady rate and autonomous monetary policy, then the capital movements are limited.

What to choose?

If we take a look back into the history, until the World War I the economy was based on the golden standard which guaranteed cover for printed money in gold. As long as countries respected the golden standard and kept sufficient amount of gold in which currencies could be converted, the exchange rate was fixed (Mishkin 2006, 469). World War I ended the golden standard. Installment financing was performed by printing money without cover, which led to uncontrolled inflation. Despite the attempt to renew the golden standard after the war, including the attempt of the "partial golden standard of exchange" adopted on the Genoa Conference in 1922 which allowed smaller countries to keep in reserves currencies of a few big countries – whose reserves would be only in gold, the beginning of the big economic crisis in 1929 put a final end to all attempts for return of the golden standard.

The end of World War II and the need to recover from its consequences has definitely imposed the fact that the economic recovery is impossible without opening markets, and the growth of international trade is impossible without steady and predictable rules of trade exchange, synchronized between larger numbers of countries. Therefore, at the Breton Wood pact in 1944, the International Monetary Fund and the International bank of reconstruction and development were established; and the basis of a new international monetary system was set, which assumed fixed exchange rates towards the US Dollar and an unchangeable dollar price towards the gold of 35 USD for an ounce. Member states kept their official state reserves mostly in gold or dollar assets and they had the right to sell their dollars to the Federal reserves for gold at official price. The system was based on the golden standard of exchange, with the dollar as a key reserve currency (Krugman and Obstfeld 2009, 515). According to the Pact from 1944, the exchange rate could be changed only when a country for a longer period faces an imbalance of payments, regardless if this imbalance is a result of its deficit or surplus. The IMF had a key role in preserving the fixed exchange rate. In order to keep the fixed rate when countries have a deficit in the balance of payment and when they lose their reserves, the IMF borrows foreign currency reserves collected from other member states (Mishkin 2006, 473). If these loans are not sufficient for reaching balance of payments, this country is allowed to make devaluation and to set a new, lower exchange rate for its own currency.

The main flaws of the Breton Wood pact, which led to its end in 1971were: (a) IMF did not have instruments to force countries with surplus to make revaluation and to increase the value of this exchange rate towards other currencies and (b) the USA, as a country of the reserve currency was not able to make a devaluation of the dollar even when it was obvious that the value of the dollar is overrated, because the devaluation of the dollar would cause a system imbalance.

After the end of the golden – dollar standard and the system of fixed exchange rate within the IMF, in the 80s and the 90s of the past century mostly transitional regimes were used in the exchange rate policies, such as soft control, moving pegs regimes and flexibly managed interval regimes. The application of these regimes was intended to reconcile two conflicted interests – to decrease inflation and to preserve export competitiveness. However, it proved to be very difficult to create a synergy of the advantages from both extreme exchange rate varieties: the advantage of having discipline in the fixed rate and stronger market effect with the fluctuating rate. Fixed regimes proved to be more efficient in stopping the inflation, especially the hyperinflation, while flexible regimes enable greater monetary autonomy and use of the exchange rate as a stabilizer for economy flows. Therefore, in the last period bipolar view is gaining significance, while firm control and free floating are the only two regimes compatible with the current degree of integration of the financial market.

We must outline that the monetary theory and practice does not have a universal rule for choosing a "good" regime for the exchange rate. Every country sustains the exchange rate which, as a final result of expenses in the balance of payment and the overall financial relations with abroad, is most appropriate at a certain development stage (Jovović 2011, 58). From rigidity point of view, between the fixed and free floating regimes of the exchange rate, there is the following division:

1. Fixed exchange rate regimes: (a) Monetary union (*monetary union*); (b) dollarization or euroization (*dollarization, euroization*); and (c) Currency board (*currency board*);
2. Moderate exchange rate regimes: (a) adjustable parities (*adjustable peg*); b) moving parities (*crawling peg*); (c) Basket currency (*basket peg*); and (d) Target zone (*target zone*);
3. Flexible exchange rate regimes: (a) manager of controlled fluctuation (*managed floating*); and (b) Free fluctuation (*clean floating*);

3.2.1 Fixed regimes of foreign exchange rate

These are the fixed regimes of Foreign Exchange rate: (a) monetary union, or an irrevocable fixation of the rate for the currencies of the members of the union and introducing a unique common hyper-national currency – the member states of the monetary union abandon their monetary independence and transfer it to the common institutions of the union; (b) unilateral introduction of a foreign currency, most frequently the American dollar or the euro, as a legal means of payment in a country - the country introducing the dollar, the euro or another foreign currency as a legal and unique means of payment, unilaterally gives up its possibility to create its own national monetary policy as a possible response to the needs of the domestic economy; (c) running the policy of exchange rate by relating it to a chosen foreign anchor currency at a fixed rate and with full convertibility of the anchor currency into the domestic one and vice versa (currency board) – the country abandons the independent monetary policy and the emitting role of monetary authorities, while firm rules prevent the creators of economic policy from emitting money without security (money without cover).

The main advantages of the fixed rate policy are the monetary discipline, the low inflation, the resistance to shocks arising from the domestic money market, credibility of economic policy, safety at long-term business relations with foreign countries and real overview of the profitability of foreign investments in domestic projects.

The main disadvantages of the fixed rate policy is the loss of independence while governing the monetary policy, the domestic is currently frequently overestimated, which decreases the competitiveness of the domestic economy; and the need for larger foreign currency reserves intended for defense of the rate, having no possibility to use the exchange rate as an instrument to achieve balance of payment equilibrium and to synchronize the foreign and the domestic prices.

3.2.2. Moderate regimes of foreign exchange rates

Moderate regimes have been created as a compromise between two extreme approaches of the exchange rate policy – the fixed regime on one part and the flexible regimes on the other. These are: (a)

adjustable peg – monetary authorities fixely define the parity of their currency with another, spare currency – mostly one of the three most important currencies (euro, dollar, yen) and they are bound to preserve this fixed parity, by allowing fluctuation around the fixed, defined central parity within previously defined, very narrow margins; (b) *crawling peg* – in order to move the nominal exchange rate, the conditions of defined rules have to be met, or criteria which consider the differences in the inflation rates of the country and its trade partners, or the changes in the competitiveness which define the change of the external position of a certain country; (c) *basket currency* – monetary authorities fixely define the parity of their currency compared to a basket of currency – average ponder value of several currencies and are bound to defend this fixed peg by allowing a fluctuation around a defined central; parity within previously defined, narrow margins; the choice of basket currency is made in order to represent the most important trading partners of a country, and (d) *targeted regime* – monetary authorities keep the exchange rate within a previously defined, relatively wide corridor around a chosen central parity (10% to 15%). The crawling, or moving corridor (*crawling band*) of the exchange rate regime means that the adjustment of the chosen parity with macroeconomic variables is performed periodically – when the officially defined rate exceeds the defined margins, and a new official rate is set, with new fluctuationg limits. The monitoring corridor (*monitoring band*) in the exchange rate regimes means that the monetary authorities do not necessarily have to defend the borders of the band, but they only react upon their opinion and estimations.

3.2.3. Flexible regimes of foreign exchange rates

Flexible regimes include: managed or controlled fluctuation (*managed floating*) and free fluctuation (*clean floating*).

The free or clean floating is a theoretical category which does not exist in practice. Even the most developed counties cannot afford releasing the foreign exchange rate and leaving it exclusively to the free actions of the market regulations of demand and offer. Therefore, in reality, we can see the managed, or dirty floating, which does not include previously set targets of the foreign exchange rate – it is basically set on the market, and the monetary authorities occasionally intervene, when the oscillations of the rate get an extremely destabilizing character.

The main advantage of the flexible regimes of foreign exchange rate is the autonomy in managing the monetary policy, the automatism in balancing the payments, preventing the possibility of under or over estimations of the domestic currency, efficient adjustments to the external changes, decreased need for foreign reserves and equalized domestic and foreign prices.

Its main disadvantages are the unpredictability, higher risk in business activities with foreign countries and lack of stimulation for long-term business arrangements, bigger exposure of the domestic economy to the various shakes on the world market, and difficulty to control monetary inflations.

4. CONCLUSIONS

The possibility to compare prices, or expressing the value of items subject to international trade in currencies from different regions, is a pre-condition for international trade to occur, the exchange rate is used as a base for making the comparison between values, and it represents the price of one value expressed through units of the other currency. The exchange rate is formed on the foreign exchange market – a place where the supply and the demand for a specific currency meet.

The character of the transactions – buying and selling foreign currencies or bank deposits which happen on the foreign exchange market, depending on the timeframe of their execution can be prompt, or immediate – when transactions happen at the moment of conclusion, or maximum within the deadline defined with the speed of executing the warrant (payment order) for exchange of values, or it can be a term transaction, when the exchange of values happens in future, after a day, or at a date which is periodically different than the date of conclusion, upon a rate agreed on the conclusion date.

The action of buying or selling currencies at the foreign exchange market, especially on the term market, includes an exposure to potential currency risks. With the purpose of protection, participants on the foreign exchange market undertake measures of risk management, which basically

go into two directions - considering currency risks as a threat and taking measures for their minimization, or accepting these risks and embracing them as an opportunity to make profit.

The exchange rate has an extremely important role in the economy of every country. Therefore, besides the influence of the market laws of supply and demand, the exchange rate is subject to various stronger or weaker, larger or smaller forms of intervention of the monetary authorities who, in search of an ideal monetary policy for regulating the exchange rate for the national currency, have positions between two extremes – fixating the exchange rate to some of the chosen anchor currencies, or total adrift of the rate to the influences from the market rules of supply and demand.

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