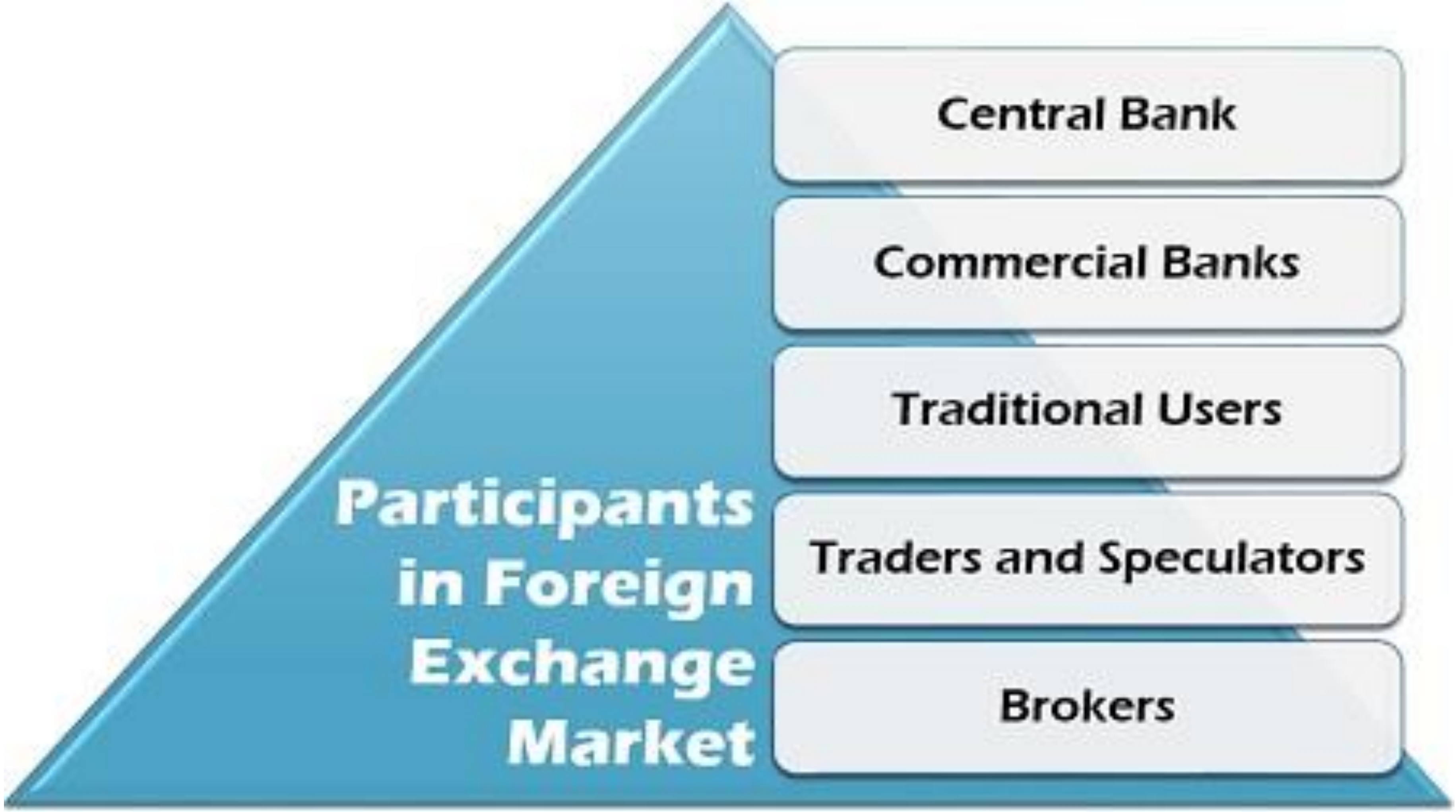
CHECK
MONEY

Foreign Exchange Market

Foreign Exchange Market

- Foreign exchange market is the market in which foreign currencies are bought and sold. The buyers and sellers include individuals, firms, foreign exchange brokers, commercial banks and the central bank.
- The foreign exchange market is the place where money denominated in one currency is bought and sold with money denominated in another currency. It provides the physical and institutional structure through which the currency of one country is exchanged for that of another country, the rate of exchange between currencies is determined, and foreign exchange transactions are physically completed.
- The primary purpose of this market is to permit transfer of purchasing power denominated in one currency to another.
- A foreign exchange market can either be completely free or restricted.



Participants in Foreign Exchange Market

Central Bank

Commercial Banks

Traditional Users

Traders and Speculators

Brokers

Participants of FOREX market

The participants here refers to the people involved in the exchange or trade of foreign currency. These can be the buyers, sellers or the intermediaries.

The participants in a forex market include the following five parties:

1. Central Bank: The central bank regulates the exchange rates of the currency of their respective country to ensure fluctuations within the desired limit and keep control over the money supply in the market.

2. Commercial Banks: The commercial banks are the medium of forex transactions, facilitating international trade and exchange to its customers along with other forex functions like making foreign investments.

3. Traditional Users: The traditional users involve foreign tourists, companies carrying out business operations across the globe, patients taking treatment in other country’s hospitals and students studying abroad.

4. Traders and Speculators: The traders and speculators are the opportunity seekers and look forward to making a profit through trading on short-term market trends.

5. Brokers: They are considered to be financial experts who act as an intermediary between the dealers and the investors by providing the best quotations.

Types of Foreign Exchange Markets:

Inter-bank or wholesale market:

A bank can purchase a foreign currency from other banks if there is a shortage. Such trading between banks is termed as the ‘inter-bank market’ wherein banks can obtain quotes, or they can contact brokers who sometimes act as intermediaries, matching a bank desiring to sell a given currency with another desiring to buy that currency.

Thus, the inter-bank is the wholesale foreign exchange market in which major banks trade currencies with each other. Large proportion inter-banks transaction volumes are handled by about 10 major foreign exchange firms.

Retail market:

Transaction size of retail foreign exchange market is very small whereas the spread between buying and selling prices is large. It consists of travellers and tourists who exchange one currency to another in the form of travellers cheques or currency notes.

Foreign Exchange Market in India

- Foreign exchange market in India came into existence in 1978 when the RBI permitted banks to under-take intra-day trading in foreign exchange.
- The foreign exchange market in India consists of 3 segments or tires.
- The first consists of transactions between the RBI and the authorized dealers (AD), which are mostly commercial banks.
- The second segment is the interbank market in which the AD’s deal with each other.

- And the third segment consists of transactions between AD’s and their corporate customers.
- As in any market essentially the demand and supply for a particular currency at any specific point in time determines its price (exchange rate) at that point.
- Prior to 1990s fixed Exchange rate of the rupee was officially determined by RBI.

Functions of Foreign Exchange Market

Foreign exchange market performs the following three functions:

1. Transfer Function:

It transfers purchasing power between the countries involved in the transaction. This function is performed through credit instruments like bills of foreign exchange, bank drafts and telephonic transfers.

2. Credit Function:

It provides credit for foreign trade. Bills of exchange, with maturity period of three months, are generally used for international payments. Credit is required for this period in order to enable the importer to take possession of goods, sell them and obtain money to pay off the bill.

3. Hedging Function:

When exporters and importers enter into an agreement to sell and buy goods on some future date at the current prices and exchange rate, it is called hedging. The purpose of hedging is to avoid losses that might be caused due to exchange rate variations in the future.

In a free exchange market, when the value of foreign currency varies, there may be a gain or loss to the traders concerned. To avoid or reduce this exchange risk, the exchange market provides facilities for hedging anticipated actual claims or liabilities through forward contracts in exchange.

Forward contract is a contract of buying or selling foreign currency at some fixed date in future at a price agreed upon now. Thus, without transferring any currency, the forward contract makes it possible to ignore the likely change in the exchange rate and avoid the possible losses from such change.

Transactions in Foreign Exchange Market

The **Foreign Exchange Transactions** refers to the sale and purchase of foreign currencies. Simply, the foreign exchange transaction is an agreement of exchange of currencies of one country for another at an agreed exchange rate on a definite date.

Some of these agreements are

Spot Exchange Rate

The spot exchange rate is the current market price for changing one currency directly for another.

Generally, the spot rate is set by the forex market, but some countries actively set or influence spot exchange rates through mechanisms like a currency peg.

Currency traders follow spot rates to identify trading opportunities not only in the spot market but also in futures, forwards, or options markets.

Understanding the Spot Exchange Rate

The spot exchange rate is usually decided through the global foreign exchange market where currency traders, institution and countries clear transactions and trades. The forex market is the largest and most liquid market in the world, with trillions of dollars changing hands daily. The most actively traded currencies are the U.S. dollar, the euro—which is used in many continental European countries including Germany, France, and Italy—the British pound, the Japanese yen and the Canadian dollar.

Trading takes place electronically around the world between large, multinational banks. Other active market participants include corporations, mutual funds, hedge funds, insurance companies and government entities. Transactions are for a wide range of purposes, including import and export payments, short- and long-term investments, loans and speculation.

Some currencies, especially in developing economies, are controlled by the government that sets the spot exchange rate. For instance, the central government of China sets a currency peg that keeps the Yuan within a tight trading range against the U.S. dollar.

Spot Exchange Rate Transactions

For most spot foreign exchange transactions, the settlement date is two business days after the transaction date. The most common exception to the rule is the U.S. dollar vs. the Canadian dollar, which settles on the next business day.

On the transaction date, the two parties involved in the transaction agree on the price, which is the number of units of currency A that will be exchanged for currency B. The parties also agree on the value of the transaction in both currencies and the settlement date. If both currencies are to be delivered, the parties also exchange bank information. Speculators often buy and sell multiple times for the same settlement date, in which case the transactions are netted and only the gain or loss is settled.

Spot Rate

A spot rate, or spot price, represents a contracted price for the purchase or sale of a currency for immediate delivery and payment on the spot date, which is normally one or two business days after the trade date. Spot rate changes with the changes in demand and supply of the currency through primary dealers. Currencies of different countries are designated by ISO code. Some of these codes are

INR	**Indian Rupee**	**AUD**	**Australian Dollar**
USD	**US Dollar**	**JPY**	**Japanese Yen**

Spot Date

The spot date refers to the day when a spot transaction is typically settled, meaning when the funds involved in the transaction are transferred. The spot date is calculated from the horizon, which is the date when the transaction is initiated. In forex, the spot date for most currency pairs is usually two business days after the date the order is placed.

Size and Nature of FOREX market

The primary purpose of FOREX market is to permit transfer of purchasing power denominated in one currency to another. It would be inconvenient for individual buyers and sellers of foreign exchange to seek out one another. So a foreign exchange market has developed to act as an intermediary. It is the largest financial market in the world with prices moving and currencies trading somewhere every hour of every business day.

The trading in foreign exchange is done over the telephone, telexes, computer terminals and other electronic means of communication called the Society for Worldwide international Financial Telecommunication (SWIFT). The communication system based in Brussels (Belgium) links banks and brokers in every financial centre. The constant link and the speed of communication enable the system to react to all the events which have an impact on the exchange rate. All these characteristics make foreign exchange market just an efficient as a conventional stock exchange market based under one roof. The currencies and the extent of participation of each currency in this market depend on local regulations that vary from country to country.

B. Forward Exchange Rate

The forward rate of exchange exists in the forward exchange market. The forward exchange market is concerned with such transactions of foreign exchange in case of which the contract to buy or sell foreign exchange is signed in the current period but the delivery of foreign exchange takes place at a future date at a price agreed upon in advance. The period for settlement of contract between the buyers and sellers of foreign exchange is usually three months.

Forward exchange rate is determined at the time of sale but the payment is not made until the exchange is delivered by the seller. Forward rates are usually quoted on the basis of a discount or premium over or under the spot rate of exchange.

A forward contract is entered into for two reasons:

(i) To minimise risk of loss due to adverse change in exchange rate (i.e., hedging) and [ii] to make a profit (i.e., speculation).

Two Exchange rate quotes: In foreign exchange market, there are two exchange rate quotes, namely, buying rate and selling rate. If a person goes to the exchange market to buy foreign currency, say, US dollars, he has to pay higher rate than when he goes to sell dollars. In other words, for a person buying rate is higher than selling rate.

The quotation for forward exchange rate can be in two different ways. It can be expressed in terms of the amount of local currency at which a dealer will buy and sell a unit of foreign currency. This is termed as outright rate. The forward rate can also be quoted in terms of points, called the forward points. These points are added to the spot rate if the foreign currency is traded at a premium. The forward points are subtracted from the price if the trading is expected to be at a discount. The rate decided in this manner is called the outright forward rate which is the forward rate adjusted for forward points which shows interest rate differentials between the countries.

Example

The forward exchange rate after 180 days can be spotted through points

Spot rate	70.50 bid/70.70 ask
Forward rate (points)-six months swap	20-25

Since the points are In ascending order, the points to be added which means exchange rate is at a premium

The forward rate after 180 days will be

70.70 bid/70.95 ask

If the forward rate is going to be at discount then the points will stated in descending order, i.e.

Spot rate 70.50 bid/70.70 ask

Forward rate (points)- six months swap 25-20

Hence the forward rate will be calculated by subtrcting the points hence the forward rat e will be

70.25 bid/70.50 ask

Resources

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2. Economicdiscussion.com
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4. Salvatore, D.: Managerial Economics in a global economy (Thomson South Western Singapore, 2001)