Mail: banishagupta2099@gmail.com
Website: https://iibf.info

Foreign exchange (FX) markets

Foreign exchange (FX) markets, also known as currency markets or forex markets, are decentralized global markets where different currencies are bought and **sold. These markets determine the exchange rates between currencies, which are essential for international trade and investment.**

FX markets operate 24 hours a day, five days a week, excluding weekends. They are decentralized, meaning there is no central exchange where all **transactions occur. Instead, trading takes place electronically over-the-counter (OTC), with participants connected through computer networks.**

By the time, it is post-lunch session for Indian FX markets; the European markets commence **their operations. When European markets are closing, US markets open up. Thus, the market quotes are available throughout.**

The world currency markets are marked by the presence of currencies like US Dollar (USD), Great British **Pound (GBP), Euro (EUR), Swiss Franc (CHF), Japanese Yen (JPY) etc, besides the other continental and exotic currencies.**

DEFINITIONS AND EXCHANGE RATE QUOTATIONS

- **Exchange Rate** refers to the **price of one currency against another currency.**
- **Spot transaction** refers to the transaction wherein the settlement takes place two **working days after the date of transaction.**
- Where the transaction and the settlement take place on the same day of the date of the **transaction itself, then such transaction is said to have taken place on Cash or Today value basis.**

• TOM transaction refers to the transaction wherein the settlement takes place one working **day after the date of the transaction. The term TOM stands for Value Tomorrow**.

• Any transaction in respect of which the settlement takes place beyond the spot **date is a Forward transaction.**

• An outright transaction is one in which a particular currency is bought against **another currency that is being sold for a given value date at a mutually agreed exchange rate.**

• Swap transaction refers to purchase and sale of a given pair of currencies against each other **for different maturity/ value dates. In effect, it is a combination of two outright deals of varying maturity dates.**

• Cross rate is the process of arriving at a value of a given currency through the medium of two different pairs of currencies, in which there is a currency which is common in both the pairs.

Exchange Mechanism

There are two methods:

1. Exchange rate, expressed as the price per unit of foreign currency in terms of the home **currency is known as the "Home currency quotation" or "Direct Quotation".**

2. Exchange rate expressed as the price per unit of home currency in terms of the foreign currency is known as the "Foreign Currency **Quotation" or "Indirect Quotation".**

Direct Quotation is used in New York and other foreign exchange markets, and Indirect Quotation is used in London foreign exchange market.

Direct Quotation: Buy Low, Sell High

The prime motive of any trader is to make profit. By purchasing the commodity at lower price and selling it at a higher price, a trader earns profit. In foreign exchange, **the banker buys the foreign currency at a lesser price and sells it at a higher price.**

Indirect Quotation: Buy High, Sell Low

A trader for a fixed amount of investment would acquire more units of the commodity when **he purchases, and, for the same amount he would part with lesser units of the commodity when he sells.**

Ready Exchange Rates

The foreign exchange dealing of a bank with its customer is known as "merchant business" and the exchange rate at which the transaction takes place is the 'merchant rate'. The merchant business in which the contract with the **customer to buy or sell foreign exchange is agreed to and executed on the same day is known as ready** transactions or cash transactions.

FACTORS INFLUENCING EXCHANGE RATES

A. Money Market

A tight monetary policy is favourable for the exchange rate because high interest rates will cool the economy and drive down inflation attracting **funds into the currency. Prospective falls in bond yields also support the currency.**

B. Fiscal Policy

The budgetary position of the government indicates the soundness of fiscal **management. A lax fiscal policy weakens the currency.**

C. Inflation

High inflation is negative for a **currency while low inflation points to a strengthening currency.**

D. Attractiveness of Country for Investment

Sound economic **fundamentals, stable government and policies and an international orientation attract foreign investment, strengthening the currency.**

E. Forex Reserves

Reserves are the ammunition that can be deployed to ward off speculative attacks on a currency**. A healthy reserves position enables the central bank to manage the exchange rate in line with its goals and domestic economic considerations.**

F. Forex Debt

Debt is in absolute terms, in relation to GDP and short-term debt is as a percentage of reserves (**liquidity ratio). High forex debt ratio is considered adverse for the currency.**

G. Agricultural Production/Food Stocks (important in emerging markets)

Threat of high inflation is less if the country is comfortably positioned as far as availability of items of mass consumption is concerned. Low inflation risk is considered favourable for the currency.

H. Rate of GDP Growth

Higher growth favours currency.

I. Political

Stability of Government is the confluence and interplay of all the above factors - past and prospective - which determines currency movements.

Different factors predominate at different times, creating uncertainty and volatility which characterize currency markets.

ROLE OF BANKS IN THE INDIAN FOREX MARKET

Banks play a crucial role in the Indian foreign exchange (forex) market. As intermediaries between participants, they facilitate the trading and settlement of foreign currencies. Here are the key roles of banks in the Indian forex market:

1. **Market Making:** Banks act as market makers in the forex market by providing buy and sell quotes for various currency pairs. They maintain bid-ask spreads, which represent the difference between the **buying and selling prices, thereby facilitating liquidity in the market. Banks continuously quote exchange rates to clients, allowing them to execute currency trades.**

2. **Interbank Trading:** Banks engage in interbank trading, where they trade currencies with other banks. This is primarily conducted through electronic trading platforms or over-the-counter (OTC) transactions. **Interbank trading helps determine the prevailing exchange rates and enables banks to manage their own currency positions and meet the needs of their clients.**

3. **Customer Transactions:** Banks offer forex services to their customers, which can include individuals, corporations, and other financial institutions. They provide foreign currency exchange services for travel**, international trade, remittances, and investment purposes. Banks buy and sell currencies on behalf of their customers, ensuring the smooth flow of funds between different currencies.**

4. **Hedging and Risk Management:** Banks assist their clients in managing currency risks through hedging strategies. They offer various hedging products, such as forwards, options, and swaps, which allow clients to **protect themselves from adverse currency**

movements. Banks provide expertise in assessing risk exposures, designing hedging strategies, and executing hedging transactions.

5. **Trade Finance:** Banks play a crucial role in facilitating international trade transactions by providing trade finance services. They issue letters of credit, provide export/import financing, and handle **trade-related documentation. Banks help businesses mitigate the risk of currency fluctuations by offering products like trade finance derivatives and currency risk management solutions.**

6. **Regulatory Compliance:** Banks operating in the Indian forex market must adhere to regulatory guidelines set by the Reserve Bank of India (RBI) and other regulatory authorities. They are responsible for ensuring **compliance with regulatory requirements related to customer identification, reporting of transactions, and maintaining adequate risk management and internal control systems.**

7. **Market Research and Analysis:** Banks employ research teams to analyse and forecast currency movements in the Indian forex market. They provide market insights, economic analysis, and forex forecasts to **clients, assisting them in making informed decisions. Banks also offer research reports and market updates to help clients understand the factors influencing exchange rates.**