EXCHANGE RATES AND FOREX BUSINESS

CH – 1 MODULE A PART 1 BFM By Ashish Jain

FOREIGN EXCHANGE 🌐 – DEFINITION AND MARKETS

1. Definition of Foreign Exchange According to the Foreign Exchange Management Act (FEMA), 1999 (Section 2):

"Foreign Exchange means foreign currency, and includes:

(i) All deposits, credits, and balances payable in foreign currency, and any drafts, traveler's cheques, letters of credit, and bills of exchange expressed or drawn in Indian currency and payable in any foreign currency.

(ii) Any instrument payable at the option of the drawee or holder thereof, or any other party thereto, either in Indian currency or in foreign currency, or partly in one and partly in the other."

Broadly, **foreign exchange** includes all claims payable abroad, such as funds held in foreign currency with banks abroad or bills/cheques payable abroad.

Key Points	Details
Foreign Exchange	All types of claims payable abroad (e.g., deposits in foreign currency, bills, cheques).
FEMA, 1999	Defines what constitutes foreign exchange in legal terms (Section 2).

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2. What Is a Foreign Exchange Transaction?

A **foreign exchange transaction** is essentially a contract to exchange funds in one currency for funds in another currency at an agreed rate, on a predetermined basis.

- **Exchange Rates** represent the price or ratio at which one currency is exchanged for another.
- **Example**: 1 US dollar (💵) = ₹82.4200 (Indian rupees), or 1 Euro (💶) = 1.05 US dollars.

These rates are **highly dynamic** and can change day to day, minute to minute, or even second to second, influenced by various economic and market factors.

🔎 **Real-Time Example: Scenario**: You are an Indian importer (🏭) needing to pay a supplier in the USA (US). When you lock in an exchange rate of 1 USD = ₹82.4200, you agree to provide rupees and receive US dollars in return. If the rate shifts by even a small fraction before you finalize the transaction, the amount of rupees needed could increase or decrease.

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3. Foreign Exchange Markets 🌍

Foreign exchange (FOREX) markets bring together a wide range of participants:

1. **Individuals**
2. **Businesses**

3. **Commercial & Investment Banks**
4. **Central Banks**
5. **Cross-border Investors**
6. **Arbitrageurs & Hedge Funds**
7. **Pension Funds**
8. **Speculators**

These entities buy or sell currencies based on commercial needs, hedging strategies, or speculative positions. The market operates via a **communication system**, with no fixed, centralized trading floor.

It functions **24 hours a day**, moving across global time zones from Tokyo (JP) and Sydney (AU) in the east through Hong Kong (HK), Singapore (SG), India (IN), Bahrain (BH), Frankfurt (DE), London (GB), Paris (FR), and finally New York (US) in the west.

🌐 Key Features of the Global FOREX Market	⏰ Explanation
24-hour operation	Markets move across time zones, ensuring continuous trading.
No geographic boundaries	Primarily communication/system-based, not tied to physical “walls.”
High liquidity	Large volumes, quick trades, and narrow spreads.
Potential for profit & losses	High volatility can yield gains, but also poses risks.

When the **London/ European** markets start their day, it's nearly lunchtime in **India**. As **India** closes, **New York** begins. Meanwhile, as **New York** runs, the eastern hubs in **Tokyo**, **Hong Kong**, and **Singapore** gear up to open.

4. Market Participants and Their Roles

🏦 Participant	🎯 Primary Purpose
Central Banks	Manage forex reserves, intervene to stabilize home currency, reduce volatility.
Commercial Banks	Offer exchange services to clients, hedge assets and liabilities, speculate on rate movements.
Investment Funds/ Banks	Move funds globally for investments, hedge positions across countries/currencies.
FOREX Brokers	Act as intermediaries, matching buyers and sellers.
Corporations	Transfer funds across borders for trade, investment, or speculative activities.
Individuals	Engage in personal/travel transactions, remittances, investments, or speculation.

These participants create vast transaction volumes for trade, travel, hedging, investments, and speculation.

🔎 **Real-Time Example: Scenario**: A multinational company (🌎 🏢) wants to purchase raw materials from an overseas supplier. They use commercial banks and sometimes FOREX brokers to convert their funds into the supplier's currency. Meanwhile, the central bank may intervene if sudden market fluctuations threaten local currency stability.

5. Dynamism of the FOREX Market ⚡

Major currency pairs (e.g., GBP/USD) can fluctuate **every three to four seconds**, totaling about **21,600** rate changes a day (15×60×24). Such rapid changes mean that **even brief distractions** can lead to different rates than those initially observed.

Market Timings

- Generally open **Monday to Friday** worldwide.
- Middle Eastern markets like Dubai, previously open on Saturdays/Sundays with restrictions (and closed on Fridays), now align with Monday–Friday operations.
- Most trades are **OTC (Over the Counter)**, concluded via telephone or digital/electronic platforms (e.g., dealing systems from banks or brokers, and internet-based services).

Large Global Banks & Time Zones

- Banks in **London** may deal with counterparts in **Paris**, **Frankfurt**, **Mumbai**, **New York**, **Tokyo**, or **Singapore**—all in different time zones.
- **Global dealing rooms** can operate around the clock. Some traders even have home-based dealing systems or use smartphone apps to trade from anywhere, at any time.

6. Market Makers & Two-Way Quotes 🤝

Major banks often act as **market makers**, offering **two-way quotes** (buy and sell). The caller can choose to buy or sell as needed, contributing to market depth and liquidity.

7. Characteristics of the Foreign Exchange Market

☑ Characteristic	💡 Description
1 24-hour market	Trades occur round the clock across global time zones.
2 OTC & Exchange-driven	Predominantly over-the-counter, but exchange-based segments also exist.
3 Global reach	No physical boundaries or centralized trading floor.
4 Supports large capital & trade flows	Accommodates significant liquidity for business, investment, and speculation.
5 Highly liquid	High volume ensures easy entry/exit for traders and investors.
6 Frequent fluctuations	Rates can change every few seconds, reflecting continuous market inputs.

7 Time zone factor in settlements	Settlements and confirmations can be affected by regional business hours.
8 Influenced by government policies & controls	Central banks and regulations can shape currency values and market dynamics.

📊 Summary Table

Topic	Key Takeaways
Definition (FEMA, 1999)	Foreign exchange covers foreign currency, deposits, credits, balances, drafts, traveler's cheques, and instruments payable in foreign currency.
Exchange Rate	The price/value/ratio at which one currency is exchanged for another (e.g., 1 USD = ₹82.4200).
Market Participants	Central & Commercial Banks, Investment Funds/Banks, FOREX Brokers, Corporations, Individuals, and others.
Global Turnover	Approx. USD 6.60 trillion/day (2020); FX swaps are ~49% of turnover, spot ~30%.
Indian Market	Daily OTC turnover rose to ~USD 34 billion (2019–20); exchange-traded derivatives at ~USD 12.2 billion (2019–20).
Market Operation	24/5 (Monday to Friday), across global time zones. No single centralized location; mostly OTC.
Characteristics of FOREX Market	24-hour nature, high liquidity, frequent rate changes, influenced by policies, large capital flows, and a global communication system.

FACTORS DETERMINING EXCHANGE RATES ⚖️

The quotations in the FOREX markets depend on the **type of delivery** of the currencies (i.e., the exchange of two currency streams).

Spot rates—which are the base quotes in FOREX—are particularly dynamic and influenced by several factors, both **fundamental** and **technical**, as well as **speculative** forces.

(a) Fundamental Reasons 📊

These involve causes or events that affect the **basic economic and monetary policies** of a government. They typically influence long-term exchange rates, though they may have less effect in the short run. Over the long run, exchange rates are linked to fundamental indicators such as:

🔑 Fundamental Factor	Effect on Exchange Rates
Balance of Payment (BOP)	A surplus in BOP often leads to a stronger home currency, while a deficit can weaken it.
Economic Growth Rate	High growth increases production and exports, raising the home currency's value (and vice versa).
Fiscal Policy	An expansionary policy (e.g., lower taxes) can boost economic growth, potentially affecting exchange rates.

Monetary Policy	Central bank actions on interest rates and money supply can strengthen or weaken the home currency.
Interest Rates	Higher domestic interest rates may attract overseas capital, causing short-term appreciation. Over time, however, high rates can slow the economy and weaken the currency.
Political Issues	Political stability often fosters economic stability, strengthening the currency. Instability can have the opposite effect.

(b) Technical Reasons ⚙

Certain **government controls** may fix a currency at an unrealistic value, leading to **sudden and volatile** exchange rate movements. Restrictions or freedoms on **capital movement** can also heavily impact rates.

Example: During the **1997 South East Asian Currency Crisis**, countries like Indonesia, Thailand, the Philippines, and South Korea experienced dramatic exchange-rate shifts when capital surged out of or into their economies.

OPEC Surpluses: Petroleum-exporting nations (e.g., OPEC countries) **often generate large surpluses when oil prices spike**. If these funds are then invested overseas, it can lead to significant **inflows** for recipient countries—strengthening their currencies.

Capital generally **moves from lower-yielding to higher-yielding currencies**, affecting exchange rates accordingly.

(c) Speculation 💹

Speculative forces can exert substantial influence on exchange rates:

Example: If speculators expect the home currency to depreciate, they might buy USD at Rs. 80.00 and later sell those USD at Rs. 80.20 when the rupee actually weakens, profiting from the 0.20 difference.

Such speculative activity:

- **Provides depth and liquidity** to the market.
- Can act as a **cushion** if opposing views prevent one-sided, contagious market moves.

EXCHANGE RATE MECHANISM 🔄

Types and Calculation

Because the FOREX market spans multiple time zones, most deals occur on a **Spot** basis:

- **Spot value date**: The second working day after the transaction date.
- The rate used in these trades is called the **Spot rate**.

When the currencies actually exchange on the value (settlement) date, it is referred to as the **delivery** of funds. Delivery can be one of the following:

1. Ready or Cash 🏦

- **Settlement**: Same day as the deal date.
- **Example**:
  - **Deal Date**: 1st Nov 2021
  - **Transaction**: Bank A buys USD 1,000,000 from Bank B @ 74.9500 (Value Cash)
  - **Settlement**: Both USD 1,000,000 and INR 74,950,000 are exchanged on 1st Nov 2021.

This is called a **Ready/Cash deal**.

2. Tom ⌛

- **Settlement**: Next working day after the deal date.

Example:

- **Deal Date**: 1st Nov 2021
- **Transaction**: Bank A buys USD 1,000,000 from Bank B @ 74.9600 (Value Tom)
- **Settlement**: Both USD 1,000,000 and INR 74,960,000 are exchanged on 2nd Nov 2021 (the next working day).

If 2nd Nov 2021 is not a working day, settlement moves to the following working day.

3. Spot 🎯

- **Settlement**: Second working day following the deal date.
- **Example**:

  - **Deal Date**: 1st Nov 2021
  - **Transaction**: Bank A (Mumbai) buys USD 1,155,000 against EUR from Bank B (Frankfurt) @ EUR/USD 1.1550 (Value Spot)
  - **Settlement**: Delivery of USD 1,155,000 and EUR 1,000,000 occurs on 3rd Nov 2021.

If either market (e.g., Mumbai or Frankfurt) is closed on those days, settlement shifts to the **next mutual working day**.

4. Forward 📅

- **Settlement**: Any day **after** the Spot date.
- **Example**:
  - **Deal Date**: 1st Nov 2021
  - **Value (Settlement) Date**: 30th Nov 2021
  - **Transaction**: Bank A buys USD 1,000,000 @ 75.3600
  - **Settlement**: USD 1,000,000 and INR 75,360,000 are exchanged on 30th Nov 2021.

Banks must ensure the forward settlement date is a **working day**, not falling on a weekend.