UNIT 4

UNIT 4 B – Foreign Exchange Market

INTRODUCTION - Foreign exchange market

Most international financial transactions involve an exchange of one currency for another. International trade as well as the movement of capital among different countries necessitate the conversion of currencies. Exchange dealers perform this task of exchanging currencies in the foreign exchange market.

A Foreign exchange market is a market in which currencies are bought and sold. Foreign Exchange market is also referred as FOREX. It provides the mechanism for exchanging different monetary units. The currency unit of a country can be exchanged for one or more than one unit of the currency of another country. *The price of one currency in terms of another is known as exchange rate*.

The demand and supply in the foreign exchange market permits the establishment of rates of different currencies in terms of local currency. These markets represent institutional arrangements where foreign exchange operations take place. It is to be distinguished from a money market where currencies are borrowed and lent. It is also to be distinguished from stock market where securities are traded.

According to Jeff Madura

"Foreign exchange market allows currencies to be exchanged in order to facilitate international trade or financial transactions. Commercial banks serve as financial intermediaries in this market. They stand ready to exchange currencies on the spot or at a future point in time with the use of forward contract."

The most active foreign exchange market is that of UK (London), followed by that of USA, Japan, Singapore, Switzerland, Hong Kong, Germany, France and Australia.

The Foreign Exchange market takes place between dealers and brokers in financial centres around the world. During the hours of business common to different time zones, they rapidly exchange shorthand messages expressing their bids for different currencies. The Foreign Exchange market has expanded considerably since President Nixon closed the gold window and currencies were left afloat vis-á-vis other currencies and speculators could profit from their transactions.

The term *foreign exchange market is used to refer to the wholesale* segment of the market, where dealings take place among the banks. *The retail segment* refers to the dealings between banks and their customers. The retail segment is situated at a large number of places. They can be considered not as FOREX markets, but as the counters of such markets.

FOREX market is the largest financial market of the world in comparison to any other market including the stock market with a daily turnover of over USD 4-5 trillion. All other markets, combined together, represent only about 15 per cent of the total volume, traded globally. Over the years, there has been a sizeable growth in foreign exchange operations. They were primarily developed to facilitate settlement of debts arising out of international trade. But these markets have developed on their own so much so that a turnover of about 3 days in the FOREX market is equivalent to the magnitude of world trade in goods and services.

The business in foreign exchange markets in India has shown a steady increase as a consequence of increase in the volume of foreign trade of the country, improvement in the communications systems and greater access to the international exchange markets. Still the volume of transactions in these markets amounting to about USD 4-5 trillion per day does not compete favourably with any well developed FOREX market of international repute.

The reasons are not far to seek. *Rupee is not an internationally traded currency and is not in great demand*. Much of the external trade of the country is designated in leading currencies of the world, viz., US dollar, Pound Sterling, Euro, Japanese Yen and Swiss Franc. Incidentally, these are the currencies that are traded actively in the foreign exchange market in India.

FEATURES OF FOREX MARKET

1. Liquidity: Forex market works with huge amount of money and gives the customers complete freedom to open or close their position of a different volume at current price.
2. No centralized Market/Over the Counter Market (OTC) : A foreign exchange market exists wherever the trade of two foreign currencies is taking place. There is no geographical location.
3. Leverage: The main distinction of working on Forex market is that the player has an opportunity to purchase and sale currency without having the full sum of money needed for operation. To make a deal the player has to make initial deposit (margin) after which the investor can make deals amount of which can exceed the invested money by many times. It is so called "leverage". So in case you deposit 10,000 INR into your account, you will have an opportunity to work with 1,000,000 INR or so.
4. Round the clock trading access: The ability to trade for 24 hours a day, five days a week.
5. Globality and Ubiquity: Trading operation may be carried out from any part of the globe, where Internet access is available.

Foreign exchange market is described as an OTC (over the counter) market as there is no physical place where the participants meet to execute their deals. It is more an informal arrangement among the banks and brokers operating in a financing centre purchasing and selling currencies, connected to each other by tele-communications like telex, telephone and a satellite communication network, SWIFT.

The markets are situated throughout the different time zones of the globe in such a way that when one market is closing the other is beginning its operations. Thus at any point of time one market or the other is open. Therefore, it is stated that foreign exchange market is functioning throughout 24 hours of the day.

However, a specific market will function only during the business hours. Some of the banks having international network and having centralized control of funds management may keep their foreign exchange department in the key centre open throughout to keep up with developments at other centers during their normal working hours.

The leading foreign exchange market in India is Mumbai, Calcutta, Chennai and Delhi. The policy of Reserve Bank has been to decentralize exchanges operations and develop broader based exchange markets. As a result of the efforts of Reserve Bank- Cochin, Bangalore, Ahmedabad and Goa have emerged as new centre of foreign exchange market. In India, the market is open for the time the banks are open for their regular banking business. No transactions take place on Saturdays.

Efficiency

Developments in communication have largely contributed to the efficiency of the market. The participants keep abreast of current happenings by access to such services like Dow Jones Telerate and Teuter. Any significant development in any market is almost instantaneously received by the other market situated at a far off place and thus has global impact. This makes the foreign exchange market very efficient as if the functioning under one roof.

In most markets, US dollar is the vehicle currency, viz., the currency used to denominate international transactions. This is despite the fact that with currencies like Euro and Yen gaining larger share, the share of US dollar in the total turnover is shrinking.

Physical Markets

In few centers like Paris and Brussels, foreign exchange business takes place at a fixed place, such as the local stock exchange buildings. At these physical markets, the banks meet and in the presence of the representative of the central bank and on the basis of bargains, fix rates for a number of major currencies. This practice is called fixing. The rates thus fixed are used to execute customer orders previously placed with the banks. An advantage claimed for this procedure is that exchange rate for commercial transactions will be market determined, not influenced by any one bank. However, it is observed that the large banks attending such meetings with large commercial orders backing up, tend to influence the rates.

Characteristics of foreign exchange market

The transactions on exchange markets are carried out among banks. Rates are quoted round the clock. Every few seconds, quotations are updated.

In terms of convertibility, there are mainly three kinds of currencies.

The *first kind* is fully convertible in that it can be freely converted into other currencies, the *second kind* is only partly convertible for non-residents, while the *third kind* is not convertible at all.

The last holds true for currencies of a large number of developing countries. It is the convertible currencies which are mainly quoted on the foreign exchange markets.