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Foreign Exchange Market Mechanisms & Conventions:

Foreign exchange market provides a forum or a meeting point where the currency of one country can be traded for the currency of another country. This kind of market is essential because different countries around the globe have different currencies for trading and that import and export of goods and services between countries is inevitable. If the trading is only within a country, local currency dealings are preferable. For example if Thailand imports aircrafts from the United States, it has to pay by U.S.Dollar currency and not by Thai bahts. From where will Thailand get U.S.Dollar currency unless there is a market for foreign exchange? So, the payment in a particular currency depends upon the exporting country or the currency preferred by the exporter. There are cases when the exporter also accepts payment in other currencies provided they fall under the "major/hard currencies" being popularly and widely traded around the globe. Examples of such currencies are U.S.Dollars, British Pounds, Euros, Japanese Yen, French Franc, Deutsche Mark and Swiss Franc. Foreign currencies are also used for direct investment in foreign countries investment options and lendings apart from export and import. The world's largest financial markets can be traced to foreign currency markets. The major participants in a foreign currency market are large commercial banks and central banks of countries.

Various aspects in Foreign Exchange Dealings

1. Spot exchange rate
2. Forward exchange rate
3. Cross exchange rate
4. Direct quotation
5. Indirect quotation
6. Spread
7. Arbitrage process

The above equation is also called as the Foreign Exchange Market Mechanisms.

A note about direct and indirect quotations:

A foreign exchange quotation can either be a direct quotation or indirect quotation.

A direct quotation is otherwise called as European quotation. It is expressed in a way that reflects the exchange of a specified number of domestic currencies vis-à-vis one unit of foreign currency.

Example: 1.43020595 NZD = USD 1 is a direct quotation for US dollars in New Zealand.

An indirect quotation is otherwise called as American quotation. It is expressed in a way that reflects the exchange of a specified number of foreign currencies vis-à-vis one unit of local currency.

Example: NZD 1 = 0.6973 USD is an indirect quotation for US dollars in New Zealand.

Two way quotations: The foreign exchange quotation typically consists of two quotations or rates: buying rate (bid price) and selling rate (ask price). Both the prices will be different because the foreign exchange dealers obviously want a profit out of each transaction. Suppose if a dealer bank quotes British pound sterling 1 = 1.50 USD “ 1.57 USD; this means that the dealer bank is ready to purchase British pound sterling at \$1.50 and sell at \$1.57.

A note about Spread and Arbitrage Process:

Spread is the difference between the ask price (which is the sale price) and the purchase price (which is the bid price). The factors affecting Spread are the currencies involved in trading, the volume of business transactions during the day and the sentiments and rumours in the foreign exchange market. The size of the Spread will be directly related to the volatility of the currency. If the involved currency is subject to high volatility, the Spread will be higher to compensate for the higher risk involved and vice versa.

Arbitrage refers to an act of purchasing a currency in one foreign exchange market at a lower price and selling it in another market at a higher price. This results in equilibrium in the exchange rates of different currencies. In spot markets, the arbitrage can take the type of geographical arbitrage or triangular arbitrage. In forward markets, the arbitrage can take the form of covered interest arbitrage.

Factors influencing the variation in exchange rates of currencies:

1. Inflation rates
2. Interest rates
3. Balance of Payment position
4. Volume of international reserves and
5. Level of activity and employment.

Forex market mechanism “ Presentation Transcript

1. FOREX MARKET MECHANISM UNIT 3 Chapter 2
2. Introduction:

“ It is a market where foreign currencies are bought and sold.

“ Example : If an Indian importer imports goods from US and has to make payments in USD, it will approach foreign exchange market to buy USD for INR.

“ According to Dr. Paul Einzig ,

“ Foreign Exchange is the system or the process of converting one national currency into another, and of transferring money from one country to another“.

3. Who are the participants?

“ Individuals: tourists, migrants

“ Firms: importers and exporters

“ Banks: short position, long position, square position

- Governments/ monetary authorities: market intervention

- International agencies: lending

- Two tier market:

- First tier: ultimate customer and banker

- Second tier: between banks

4. Classification of Participants

- Non-banking entities: business transactions and hedging

- Banks: foreign exchange dealers

- Arbitrageurs: profit seeking from variations in rates in different markets

- Speculators: profit seeking from movements in exchange rates

5. Types of Market

- Spot market

- Forward market

- Derivatives markets: currency futures and options

6. Spot Market

- Currencies traded for immediate delivery at rates prevailing at the time of transaction

- Actual delivery (electronic transfer) may take two working days

- Currency arbitrage : buying a currency at cheaper rate in one market and selling at a higher rate in another market

- Two point arbitrage

- Triangular (three point) arbitrage • three currencies

- Currency speculation : buying and holding a currency for sale at a higher rate in the near future

7. Forward Market

- Contract for future delivery

- Hedging:

- Currencies are bought or sold for forward delivery

- Reduces foreign exchange risk

- Speculation:

- Reap profit from changes in exchange rates in future (difference between forward rates and future

spot rates)

8. Future Market

- It is a derivatives market

- Currency futures market is of recent origin (1972)

- Currencies can be bought and sold in the futures market

- Size and maturity of contracts are standardized

- Transactions made with the help of brokers through the clearing house

- Margin deposit and daily marking to the market

- Hedging: to reduce risk

9. Function :

- Transfer of Purchasing Power : from one country to another and from one currency to another.

- Provision of Credit : It facilitates the growth of foreign trade, as international trade depends to a great extent on credit facilities.

- Provision of Hedging Facilities : It helps in converting the export risks and it also provides a mechanism to exporter and importer to guard them against loss arising from fluctuations in exchange rates.

10. Methods of International Payments

- Telegraphic Transfer :

- It is from bank in one country to bank in another country.

- It is done through cable telex.

- It is the quickest method.

- Mail Transfer:

- It is the transfer from bank account in one center to an account in another center within same country.

- It is done by mail.

11.

- Cheques and Bank Draft:

- Bank drafts are widely used.

- Bank draft is a cheque drawn on a bank instead of customer's personal account.

- It is more acceptable mode of payment when the person placing the tender is not known, value is rather dependent on the standing of a bank which is widely known.

• Foreign Bill of Exchange :

• It is promissory note, directing that a specified sum of money be paid to a specified person and at a specific time.

• Bills of exchange are used primarily in international trade.

12.

• Documentary Credit:

• A credit instrument such as a LETTER OF CREDIT with the condition of payment being the presentation and attachment of certain documents such as bills of landing, insurances, certificate of origin, etc.

• Issued by a bank on behalf of its creditworthy customer and for the purpose of guaranteeing payment to a third party, the BENEFICIARY.

• Often associated with international trade, they are also used domestically and locally for all sorts of purchases and payment of services.

• The Beneficiary to the transaction must present the documents listed on the Documentary Credit in order to be paid.

13. Transactions in Fx Market

• Spot Exchange :

• The foreign exchange transaction requires immediate delivery or exchange of currencies on the spot.

• The settlement takes place within 2 days in most markets.

• Exchange rate effective in this market is called spot rate.

• Such transactions occur in the market called spot market.

14.

• Forward Exchange :

• It is the agreement between two parties requiring the delivery of some specified future date; of a specified amount of foreign currency by one of the parties; against the payment in the domestic currency by the other party at a price agreed upon in the contract.

• Rate of exchange that is applicable is called forward exchange rate

• Such transactions occur in the forward market.

15.

• Forward exchange at Par when, forward exchange rate quoted is equal to the spot rate at the time of making the contract.

• Forward exchange at Premium when forward rate quoted is more than the spot rate then the foreign currency is selling at the forward premium. (i.e. dollar buys more rupees)

â€¢ Forward exchange at Discount when forward rate quoted is less than the spot rate then the foreign currency is selling at the forward discount. (i.e. dollar buys less rupees).

16.

â€¢ Swap Operation :

â€¢ Banks do it to correct their fund position.

â€¢ The spot is swapped against Forward.

â€¢ It is also the double deal where the sale/purchase of spot currency accompanied by a purchase/sale respectively of the same currency for forward delivery.

17.

â€¢ Arbitrage :

â€¢ It is the simultaneous buying and selling of foreign currency with the intention of making profits from the difference between the exchange rate prevailing at the same time in different markets.

â€¢ Example: 1\$ = Rs. 45 in US

â€¢ 1\$ = Rs. 48 in India

â€¢ The dollars will be purchased from US for Rs. 45 and sold in India for Rs. 48. Therefore, a profit of Rs. 3. Thereby, demand for \$ increases in US and Supply of dollar will increase in India. It will ultimately lead to equalizing of the exchange rate.

18. Whats More?

â€¢ The major institutions that trade foreign exchange are the commercial and investment banks and securities exchanges. Commercial and investment banks deal in a variety of different currencies all over the world. The Chicago Mercantile Exchange specializes in futures contract and the Philadelphia Stock Exchange specializes in options.

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