# FOREIGN EXCHANGE MARKET

Prepared by: Janice Maria Jose

Department of Commerce

Subject: International Finance

Academic year :2020-2021

# FOREIGN EXCHANGE MARKET

- A **foreign exchange market** or **currency market** comes into existence where currencies of different countries can be bought and sold.
- It is the market which provides the facility of converting the currency of one country into another country.
- The foreign market is also referred to as forex market is mostly an **Over-The-Counter (OTC)** market.
- There is no centralized meeting point/ physical market place where parties meet for the transacting business.
- The forex market is structurally a computerized communications network embracing all the major financial centres of the globe, where sellers and buyers of any national currency can quickly and effectively carry out any desired currency exchange.
- It refers to the process by which currencies of different countries are exchanged.

# DISTINCTIVE FEATURES

1. Global Market
2. 24-hours Market
3. Largest Market in terms of the volume of transaction.
4. High Liquidity

# TRADING CHARACTERISTICS

1. The currencies of the world are represented by a three-letter code which is the internationally accepted.
2. Some currencies are also represented by special symbols.
3. Currencies are traded against one another.
4. Each pair of currencies thus constitutes an individual product and id denoted as XXX/YYY, where YYY represents the code of the currency into which the price of one units of the currency represented by XXX  is expressed.eg: EUR/USD
5. The first currency in the pair is the base currency and the second currency is the counter currency.
6. The stronger currency in the pair is used as the base currency, and the weaker currency as the counter currency.

# MARKET PARTICPANTS

- The buyers and sellers of foreign currencies are participants in the forex market.
- First tier is the inter-bank market which is characterized by large volumes of transactions. Within the inter-bank  market, the spread is very thin on account of large volumes.
- The second tier involves the banks and the customers who either need foreign currencies or have foreign currencies for sale.

# MARKET PARTICPANTS

- The following are some important participants in the foreign exchange market.

1. Banks
2. Business Firms or Companies
3. The central Bank
4. Investment Management Firms
5. Retail Forex Brokers/Dealers

# BANKS

- Banks engage in inter-bank trading in foreign currencies as well as in trading with customers for meeting their foreign currency purchase and sale requirements.
- The inter-bank  trading may be for meeting the demands of customers or for speculative gains.
- If a banks buys more than it contracts to sell, the bank is said to be in a Long Position in that currency.
- When a bank buys less of a currency than it contract to sell, the bank is in Short Position in that currency.
- When the quantity of sale and purchase of a currency by a bank is equal, such quantity denotes a square position in that currency.

# BUSINESS FIRMS OR COMPANIES

- Business enterprises engaged in import, export or provision of cross border services would either receive foreign currencies as payment for their goods or services, or would require foreign currencies to pay for goods or services, received from the abroad.
- Such business enterprises are participant in the forex market as buyers or sellers of foreign currencies.

# THE CENTRAL BANK

- The central bank of a country is an important participant in the foreign exchange market.
- It has either official or unofficial target exchange rate for its domestic currency.
- The central bank may intervene in the market to stabilize the exchange rates around the target rates.

# INVESTMENT MANAGEMENT FIRMS

- Investment management firms are engaged in managing the funds of customers.
- Investment management firms which maintain international portfolios of financial securities need to buy and sell foreign currencies in the forex market to transact the dealing in foreign securities.

# RETAIL FOREX BROKERS/DEALERS

- The retail brokers and dealers engage in the purchase and sale of foreign currencies on behalf of their client.
- The Volume of transactions handled by such retail brokers and dealers is not very large world wide.
- But they are active participants in the forex market.

# TYPES OF TRANSACTIONS

1. Business Transactions
2. Hedging
3. Arbitrage
4. Speculation

# BUSINESS TRANSACTION

- Importers need foreign currencies to make payment for their imports.
- Exporters possess foreign currencies received as export proceeds.
- The purpose is to either acquire or dispose the foreign currencies.

# HEDGING

- The parties who are exposed to risk on account of fluctuations in the exchange rates would like to hedge their risk.
- Derivative instruments.
- Several transactions in the forex market are carried out for hedging risk.

# ARBITRAGE

- Fluctuations in the exchange rates sometimes provide opportunities for making riskless profits.
- The exchange rates for a pair of currencies may vary slightly between different centres.
- When such variations exceeds the transaction cost of buying and selling the pair of currencies in two markets, there arises an opportunity for making riskless profit by buying in the centres offering low rates and selling in the centre offering higher rates.
- Arbitrageurs.

# SPECULATION

- The fluctuation in the exchange rates of different currencies offer sufficient opportunities for seeking speculative gains.
- It is basically making short-term profit from difference in rates or prices of assets.
- A speculator buys an asset in anticipation of increase in the price of asset in the near future.
- He may engage in short selling an asset when he anticipates a fall in the price of the asset in the near future.

# FINANCIAL INSTRUMENTS

1. Spot Contracts
2. Forward Contracts
3. Futures
4. Options
5. Swaps

# SPOT CONTRACTS

- A spot transaction is one in which the actual exchange of currencies takes place immediately.
- The delivery of the currencies takes place on the second working day of the contract.- this is the international conventions.
- Spot date.- delivery date.
- Cash or ready spot contract.
- TOM
- Future spot

# FORWARD CONTRACTS

- Currencies are bought and sold for delivery on a future date.
- A buyer and seller agree on an exchange rate for exchange of currencies on a future date.
- The actual delivery of currencies takes place only on such future date at the rate already agreed upon, regardless of the market rates.

# FUTURES

- Contracts for exchanging currencies in the future at a predetermined exchange rate.
- Standardized contract
- Maturity dates
- Organized exchange
- Clearing house
- Liquidity

# OPTIONS

- Contract that gives the buyer of the option the right but not the obligation to buy or sell a particular currency at a pre-agreed exchange rate.
- Strike rate.
- Call option
- Put option
- Option premium

# SWAPS

- It is the purchase of one currency against another currency for one value date and the simultaneous reversal of that exchange contract for a different value date.
- Spot against future basis
- Future against future basis
- Spot against spot basis