Unit -3

Foreign exchange market and exchange rates

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1. **What are the main functions of Foreign Exchange Market ?**

   Ans: **Foreign Exchange Market** is the market where the buyers and sellers are involved in the buying and selling of foreign currencies. In other words , the market in which the currencies of different countries are bought and sold is called as a foreign exchange market. A foreign exchange market performs three important functions relating to the buying and selling of foreign currencies. These are discussed below.

   a) Transfer Function:

      The basic function of the foreign exchange market is to transfer purchasing power between countries, i.e., to facilitate the conversion of one currency into another. It basically includes the **conversion of one currency to another,** wherein the role of FOREX is to transfer the purchasing power from one country to another. The international clearing function performed by foreign exchange markets plays a very important role in facilitating international trade and capital movement. The transfer function is performed through a use of credit instruments, such as bank drafts, bills of foreign exchange, and telephone transfers

   b) **Credit Function:**

      Foreign Exchange Markets provide a **short-term credit** to the importers so as to facilitate the smooth flow of goods and services from country to country. Exporters may get pre shipment and post shipment credit. Credit facilities are available also for importers. An importer can use credit to finance the foreign purchases. Bills of exchange used in the international payments normally have a maturity period of three months.Thus, credit is required for that period to enable the importer to take possession of goods, sell them and obtain money to pay off the bill.

c) **Hedging Function:**

A **foreign exchange hedge** (also called a FOREX hedge) is a method used by companies to eliminate or "hedge" their foreign exchange risk resulting from transactions in foreign currencies. In other words Hedging is the act of equating one's assets and liabilities in foreign currency to avoid the risk resulting from future changes in the value of foreign currency. In a situation of exchange risks, the foreign exchange market performs the hedging function. The parties to the foreign exchange are often afraid of the fluctuations in the exchange rates, i.e., the price of one currency in terms of another. The change in the exchange rate may result in a gain or loss to the party concerned.

Thus, due to this reason the foreign Exchange Market provides the services for hedging the anticipated or actual claims/liabilities in exchange for the **forward contracts**. A forward contract is usually a three month contract to buy or sell the foreign exchange for another currency at a fixed date in the future at a price agreed upon today. Thus, no money is exchanged at the time of the contract.

2. What are the different types of transactions undertaken in a foreign Exchange market ?

Ans: According to Kindle-Berger, "the foreign exchange market is a place where foreign moneys are bought and sold." Foreign exchange market is an institutional arrangement for buying and selling of foreign currencies. Exporters sell the foreign currencies. Importers buy them. This exchange of foreign currencies takes place through the following types of transactions.

a) Spot Market or Exchange:

The term spot exchange refers to the class of foreign exchange transaction which requires the immediate delivery or exchange of currencies on the spot. In practice the settlement takes place within two days in most markets. The rate of exchange effective for the spot transaction is known as the spot rate and the market for such transactions is known as the spot market.

b) **Forward Market or Transaction :** The forward transactions is an agreement between two parties, requiring the delivery at some specified future date, usually 90 after days of a specified amount of foreign currency by one of the parties, against payment in domestic currency be the other party, at the price agreed upon in the contract. The rate of exchange applicable to the forward contract is called the forward exchange rate and the market for forward transactions is known as the forward market. Forward exchange facilities, obviously, are of immense help to exporters and importers as they can cover the risks arising out of exchange rate fluctuations

c) **Future Transaction:** The future transactions are also like the **forward transactions** and deals with the contracts in the same manner as that of normal forward transactions. But however, the transactions made in a future contract differ from the transaction made in the forward contract. While a forward contract is tailor made for the client by his international bank, a future contract has standardized features the contract size and maturity dates are standardized. Futures can be traded only on an organized exchange and they are traded competitively.

d) **Option Transactions:** The foreign exchange option gives an investor the **right, but not the obligation** to exchange the currency in one denomination to another at an agreed exchange rate on a pre-defined date. An option to buy the currency is called as a **Call Option**, while the option to sell the currency is called as a **Put Option.** Buying or selling the underlying asset via the option is known as exercising the option. The stated price paid (or received) is known as the exercise or striking price. The buyer of an option is known as the long and the seller of an option is known as the writer of the option, or the short. The price for the option is known as premium.

e) **Swap Transactions:** The Swap Transactions involve a **simultaneous borrowing and lending** of two different currencies between two investors. Here one investor borrows the currency and lends another currency to the second investor. The obligation to repay the currencies is used as collateral, and the amount is repaid at a **forward rate.** The swap contracts allow the investors to utilize the funds in the currency held by him/her to pay off the obligations denominated in a different currency without suffering a foreign exchange risk.

f) **Arbitrage**
Arbitrage is the simultaneous buying and selling of foreign currencies with intention of making profits from the difference between the exchange rate prevailing at the same time in different markets

This is how the Foreign exchange transaction involves the conversion of a currency of one country into the currency of another country for the settlement of payments.