Unit -3

Foreign exchange market and exchange rates

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1. **What is the difference between Future and Forward transactions in the foreign Exchange markets ?**

   Ans: The future transactions in a foreign exchange market are also 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 differs from the transaction made in the forward contract on the following grounds:

a) **Definition:** A forward contract is an agreement between two parties to buy or sell an asset (which can be of any kind) at a pre-agreed future point in time at a specified price. A futures contract is a standardized contract, traded on a futures exchange, to buy or sell a certain underlying instrument at a certain date in the future, at a specified price.
b) **Stricture and Purpose**: The forward contracts can be customized on the client's request, while the future contracts are standardized such as the features, date, and the size of the contracts is standardized.
c) **Transaction Methods**: The future contracts can only be traded on the organized exchanges, while the forward contracts can be traded anywhere depending on the client's convenience.
d) **Brokerage:** No margin is required in case of the forward contracts, while the margins are required of all the participants and an initial margin is kept as collateral so as to establish the future position.
e) **Guarantees :** No guarantee of settlement until the date of maturity only the forward price, based on the spot price of the underlying asset is paid on the other hand in case of Future transactions Both parties must deposit an initial guarantee (margin). The value of the operation is marked to market rates with daily settlement of profits and losses.
f) **Method of Pre termination :**In case of Forward contracts Opposite contract with same or different counterparty. Counterparty risk remains while terminating with different counterparty. Again for future contracts there is opposite contract on the exchange.

2. **What is the difference between Spot and Forward exchange rate ?**

   Ans: A spot rate is a contracted price for a transaction that is taking place immediately (it is the price on the spot). A forward rate, on the other hand, is the settlement price of a transaction that will not take place until a predetermined date in the future; it is a forward-looking price. Usually forward exchange rates are calculated on the basis of Spot exchange rates. Following are the main differences between Forward and Spot exchange rates.

   a) **Time period**: A spot rate, or spot price, represents a contracted price for the purchase or sale of a commodity, security, or currency for immediate delivery and payment on the spot date, which is normally one or two business days after the trade date.On the other hand a forward contract, or futures contract, involves an agreement of contract terms on the current date with the delivery and payment at a specified future date.
   b) **Methodology**: The spot rate is the current price of the asset quoted for the immediate settlement of the spot contract.It is determind by the forces of demand and supply. Contrary to a spot rate, a forward rate is used to quote a financial transaction that takes place on a future date and is the settlement price of a forward contract. However, depending on the security being traded, the forward rate can be calculated using the spot rate.
   c) **Flexibility:** The spot exchange rate is very much flexible which keeps on changing every minute. But as Forward exchange rate is contracted , it is stable and doesn't change until the contract is over.
   d) **Simplicity:** The spot exchange is the simplest of all exchange rates it is simply the current exchange rate in the market. On the other hand fixing the forward exchange rate is very complicated and requires many factors to be considered.
   e) **Payments :** Forward exchange rate is determined at the time of sale but the payment is not made until the exchange is delivered by the seller.But in spot exchange the exchange id delivered within two days.