DAY-5

Exchange Rates & Forex Market

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The course contains material for a total of 6 days. The materials are designed in such a way that it will give an overview to Macroeconomics. The materials designed as a part of bootcamp are self-explanatory. Video linkshave been added wherever needed. Team FEBS wishes you a happy learning!

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EXCHANGE RATES

An Exchange rate can be described as **"The rate at which one currency can be exchanged with another between nations or economic zones".**

For example-

On July 13, 2022, the USD/INR rate stands at 79.66. Meaning it takes 79.66 Indian Rupees to buy 1 US Dollar.

https://youtu.be/itoNb1lb5hY

Why do we need an exchange rates?

The government needs to export and import certain resources to and from other countries. But not all currencies in the world have the same value. The value of a currency depends on many factors like the strength of the economy, outstanding loans, and interest rates in the country. So, in order to decide the worth of their resources and products in foreign currency, countries need a currency exchange rate

Direct Quotation & Indirect Quotation

When the price of foreign currency is quoted directly in terms of number of units of the domestic currency it is termed as Direct quotation.

Example: USD/INR

$1=₹79.66

When the price of foreign currency is quoted directly in terms of number of units of the domestic currency it is termed as Indirect Quotation.

Example:

INR/USD

₹1=$0.013

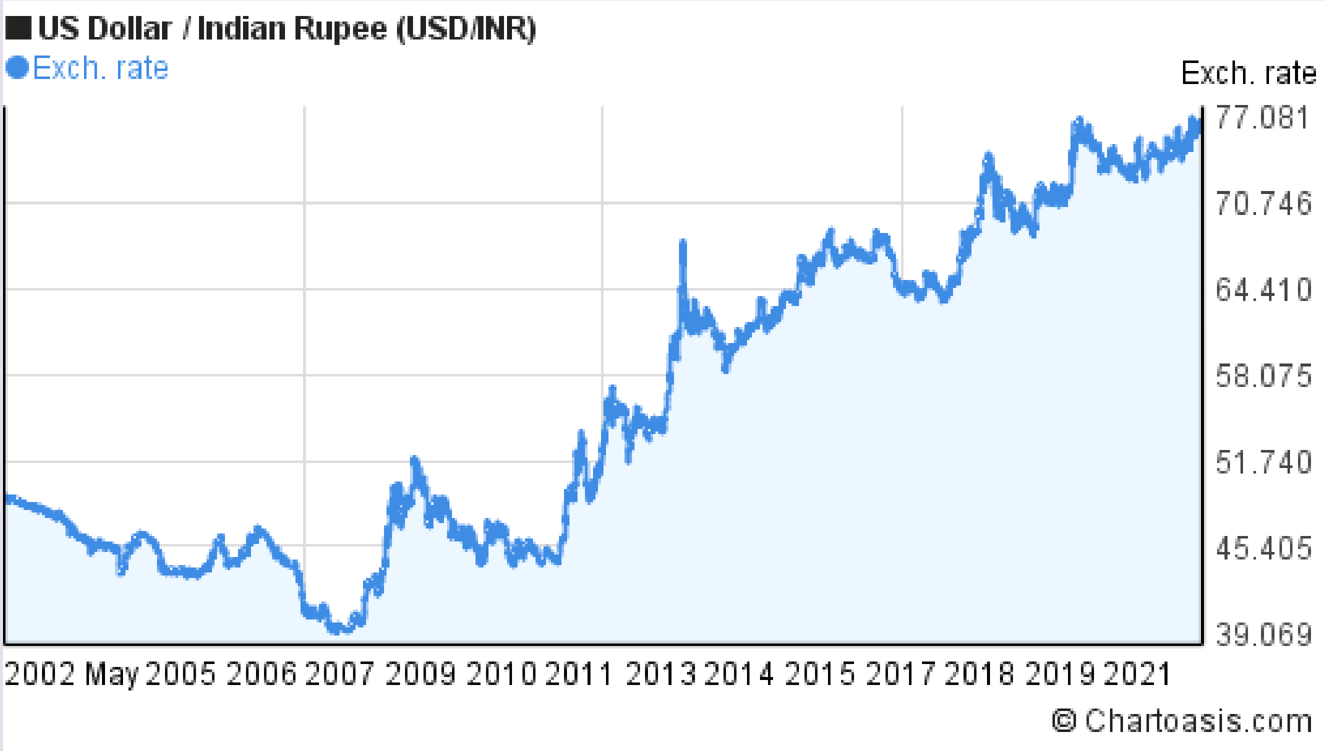
Base currency & counter currency:

The exchange rate has two components, the base currency, and the counter currency.

In a direct quotation, the foreign currency is the base and the domestic currency is the counter.

In an indirect quotation, the domestic currency is the base and the foreign currency is the counter.

Most exchange rates list the USD as the base currency. Exceptions, in this case, include the Euro and the Commonwealth currencies such as Great Britain Pound (GBP), Australian Dollar (AUD), and the New Zealand Dollar (NZD).



Exchange rates of USD/INR for last 20 Years

Types of exchange rates:

Since exchange rates depend on factors like the strength of the economy, interest rates in the country, etc, any changes in these factors will lead to changes in exchange rates. Just like stocks in the stock market go through fluctuations due to various factors, exchange rates also change.

In general, the rate system falls into two categories:

- A **fixed exchange rate** is when the government or central bank binds the exchange rate of the country's official currency against the currency of another country or the price of gold. For example, the Hong Kong dollar is pegged to the U.S. dollar in a range of 7.75 to 7.85. This means the value of the Hong Kong dollar to the U.S. dollar will remain within this range.
- A **free-floating exchange rate** rises and falls due to changes in the **foreign exchange market.**

Case of restricted currencies:

Exchange rates can also be different for the same country. Some countries have restricted currencies, limiting their exchange to within the countries' border.

In some cases, there is an **onshore rate** and an **offshorerate**. Generally, a more favorable exchange rate can often be found within a country's borders versus outside its borders. Also, a restricted currency can have its value set by the government. For example, China's Yuan is a restricted currency controlled by the government. It is allowed in a band of 2% from the midpoint set by the government.

Cash value and Forward value of exchange rates:

Exchange rates can have what is called a **spot rate**, or cash value, which is the current market value. Alternatively, an exchange rate may have a **forward value**, which is based on expectations for the currency to rise or fall versus its spot price.

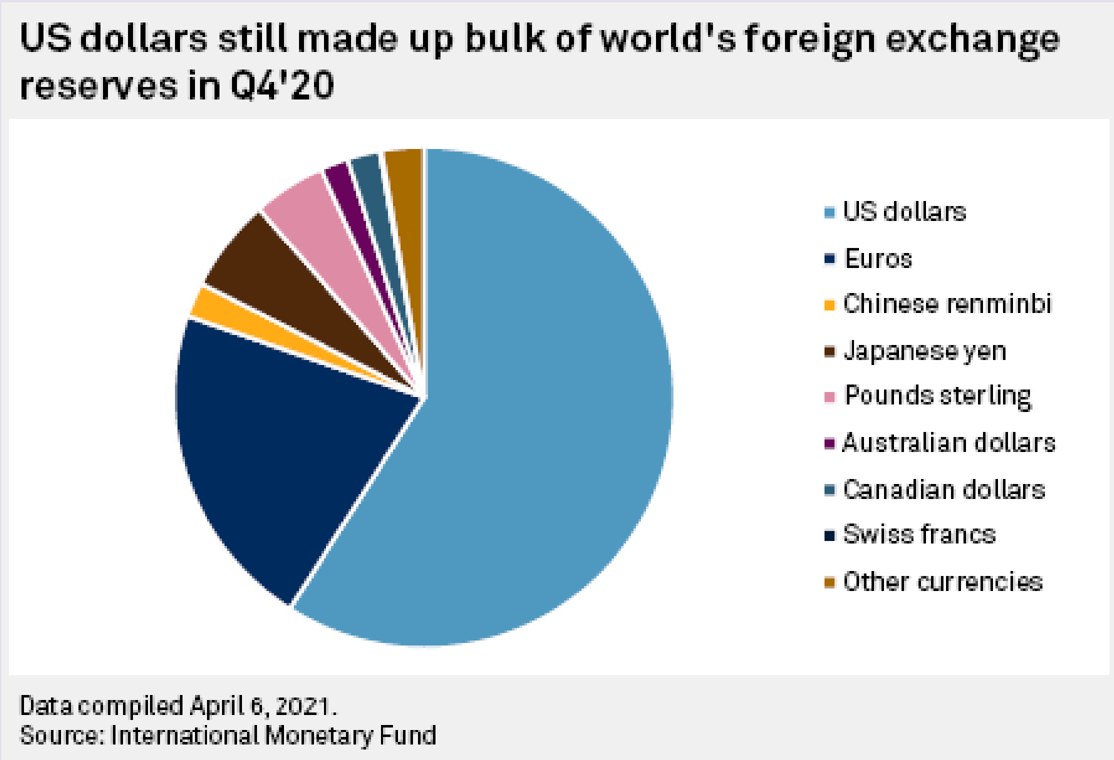
Forward rate values may fluctuate due to changes in expectations for future interest rates in one country versus another. For example, If a country’s currency is expected to rise for any reason, the investors will demand more of the currency to realize a profit based on that expectation. It can cause immediate demand increases for domestic currency relative to foreign currencies.

Effect of imports and exports of a country:

A domestic country that exports more goods than its imports will experience a higher demand for its currency, and thereby, will see its exchange rate increase relative to foreign currencies.

Special considerations:

Special consideration for the U.S. dollar is that it is the global federal reserve currency, which increases the baseline demand for the U.S. dollar relative to other currencies. Various "safe-haven" currencies are believed to be stable and attract foreign capital when the global economic outlook is uncertain. It includes currencies like the U.S. dollar, Euro, Japanese yen, and Swiss franc.



FOREX MARKET

The foreign exchange market is a global decentralized market for the trading of currencies. This market determines the foreign exchange rates for every currency.

https://youtu.be/NhFlqFVBmxc

An interesting aspect of world forex markets is that there are no physical buildings that function as trading venues for the markets. Instead, it is a series of connections made through trading terminals and computer networks. Participants in this market are institutions, investment banks, commercial banks, and retail investors.

According to the Bank for International Settlements, the preliminary global results from the 2019 Triennial Central Bank Survey of Foreign Exchange and OTC Derivatives Markets Activity show that trading in foreign exchange markets averaged US$6.6 trillion per day in April 2019. This is up from US$5.1 trillion in April 2016. Measured by value, foreign exchange swaps were traded more than any other instrument in April 2019, at US$3.2 trillion per day, followed by spot trading at US$2 trillion.[3]

The $6.6 trillion break-down is as follows:

- $2 trillion in spot transactions
- $1 trillion in outright forwards
- $3.2 trillion in foreign exchange swaps
- $108 billion currency swaps
- $294 billion in options and other products

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