Part 1 International Finance

1. “Foreign Exchange Market is a stock market in which the currencies of other countries are bought and sold”.Explain the statement in light of the Advantages and Disadvantages of the Foreign Exchange Market.

Advantages:

International Trade: Every country has its currency and therefore, to facilitate trade activities between two countries, the forex market is essential.

Trading Option: For the speculators or traders, the foreign exchange market is just like other financial markets where they can make money on short-term fluctuations in the currencies.

Flexibility: We know that the forex market is a twenty-four-seven market, and there is no minimum or maximum limit on the exchange amount. It provides the flexibility of investment or exchange to the traders.

Low Transaction Costs: Since brokers are not very much entertained in the forex market, the transaction cost (called ‘spread’) charged by the dealers is reasonably low if compared to other financial markets.

Inflation Control: To maintain the economic stability in the country and control situations like inflation, the central bank maintains a forex reserve which consists of currencies of different countries around the world.

Disadvantages:

Counterparty Risks: The forex is highly unregulated with no central authority for currency exchange or trading risk mitigation. Thus, it may encounter the risk of non-fulfillment of the obligations by any of the parties involved in such a contract.

Operational Risks: Since forex is a twenty-four hours market, it is difficult to manage its operations in humans. As a result, the traders and MNCs rely on the algorithms, and trading desks spread, respectively, to safeguard their investment in their absence.

2. Elaborate the Characteristics of the Foreign Exchange Market.

Market Transparency: It is effortless to monitor the fluctuations in the value of currencies of different countries in a forex market easily through account tracking and real-time portfolio, without the involvement of brokers.

The dollar is an Extensively Traded Currency: The USD, which is paired with almost every country's currency and listed on the forex, is the most widely traded currency in the world.

Most Dynamic Market: The value of the currencies in the forex market keeps on changing every second and functions twenty-four hours a day. This makes it one of the most active markets in the world.

International Network of Dealers: The foreign exchange market establishes a medium among the dealers and also with the customers. There are dealer institutions located globally to carry out exchange and trading activities.

"Over-The-Counter" Market: In different countries, the forex market is the highly unregulated market initiating over-the-counter trade by the banks through telex and telephone.

High Liquidity: The currency is considered to be the most widely traded financial instrument across the globe, making the forex market highly liquid.

Twenty-Four-Hour Market: The foreign exchange market is operational for twenty-four hours of the day, initiating the active trade and exchange of currencies at any time.

3. Who are the Participants in the Foreign Exchange Market?

4. Explain the Types of Foreign Exchange Rates.

1. Fixed Exchange Rate: Under this system, the exchange rate for the currency is fixed by the government. Thus, the government is responsible to maintain the stability of the exchange rate. Each country maintains the value of its currency in terms of some 'external standard' like gold, silver, another precious metal, or another country's currency.

- The main purpose of a fixed exchange rate is to maintain stability in the country's foreign trade and capital flows.
- The central bank or government purchases foreign exchange when the rate of foreign currency rises and sells foreign exchange when the rates fall to maintain the stability of the exchange rate.
- Thus, the government has to maintain large reserves of foreign currencies to maintain a fixed exchange rate.
- When the value of one currency(domestic) is tied to another currency then this process is known as pegging and that's why the fixed exchange rate system is also referred to as the Pegged Exchange Rate System.
- When the value of one currency(domestic) is fixed in terms of another currency or in terms of gold, then it is called the Parity Value of currency.

2. Flexible Exchange Rate System: Under this system, the exchange rate for the currency is fixed by the forces of demand and supply of different currencies in the foreign exchange market. This system is also called the Floating Rate of Exchange or Free Exchange Rate. It is so because it is determined by the free play of supply and demand forces in the international money market.

- Under the Flexible Exchange Rate system, there is no intervention by the government.
- It is called flexible because the rate changes with the change in the market forces.
- The exchange rate is determined through interactions of banks, firms, and other institutions that want to buy and sell foreign exchange in the foreign exchange market.
- The rate at which the demand for foreign currency is equal to its supply is called the Par Rate of Exchange, Normal Rate, or Equilibrium Rate of Foreign Exchange.

3. Managed Floating Exchange Rate: It is the combination of the fixed rate system (the managed part) and the flexible rate system (the floating part), thus, it is also called a Hybrid System. It refers to the system in which the foreign exchange rate is determined by the market forces and the central bank stabilizes the exchange rate in case of appreciation or depreciation of the domestic currency.

- Under this system, the central bank acts as a bulk buyer or seller of foreign exchange to control the fluctuation in the exchange rate. The central bank sells foreign exchange when the exchange rate is high to bring it down and vice versa. It is done for the protection of
- the interest of importers and exporters.

- For this purpose, the central bank maintains the reserves of foreign exchange so that the exchange rate stays within a targeted value.
- If a country manipulates the exchange rate by not following the rules and regulations, then it is known as Dirty Floating.
- However, the central bank follows the necessary rules and regulations to influence the exchange rate.

5. Distinguish between Fixed Exchange Rate and Floating Exchange Rate.

Fixed Exchange Rate	Basis	Flexible Exchange Rate
The system of exchange rate in which exchange rate is officially declared and fixed by the government.	Meaning	The system of exchange rate in which value of a currency is allowed freely to float as determined by demand for and supply of foreign exchange.
It ensures stability in international money market / exchange market. Day to day fluctuations are avoided.	Stability	It causes instability in the international money market.
It implies low risk and low uncertainty of future payments. It encourages international trade.	International Trade	Instability in foreign exchange market causes instability in the area of international trade.
It discourages venture capital in international money market.	Venture Capital	It encourages venture capital in international money market.
It is often supported with huge international reserves of gold. This is because of different currencies are directly or indirectly convertible into gold.	International Reserves	It is not to be supported with international reserves

6. What is Purchasing Power Parity? Give the Advantages Of Purchasing Power Parity.

A theoretical exchange rate that allows you to buy the same amount of goods and services in every country. Example: If you want to live inexpensively, and can move to any country in the world, compare the prices of a McDonald's Big Mac. Government agencies use it to compare the output of countries that use different exchange rates.

Advantages:
1. PPP exchange rates are stable compared with the market. PPP exchange rates stay relatively stable when compared with financial world market rates. Comparing GDP using market rates can mean more volatility in comparisons, even when the individual countries' markets are stable.

2. It accounts for non-traded goods. GDP measures a country's economic productivity as it relates to the sale of tangible, internationally traded goods. However, PPP accounts for the

cost of non-traded goods and services—like haircuts or massages—which also speaks to the productivity of a given economy.

3. It provides real-world examples of living costs and standards. Every year, The Economist releases a comparative list of what 55 countries around the world charge for a McDonald's Big Mac called the Big Mac Index. This example of PPP uses a recognizable good as a point of comparison between the living costs around the world.

7. What is Interest Rate Parity?

The Interest Rate Parity theory is a hypothesis that suggests that the difference between the spot rate and forward exchange rate of two currencies is equal to the differential of the interest rates of two countries.

According to the theory, the interest rate differences in the two countries are offset by the difference in the spot exchange rate and forward exchange rate differences of the currencies of these countries over a period of time.

8. What is the Fisher Effect?

The Fisher Effect is an economic hypothesis developed by economist Irving Fisher to explain the link between inflation and both nominal and real interest rates. According to the Fisher Effect, a real interest rate is equal to the nominal interest rate minus the expected inflation rate. As a result, real interest rates drop as inflation rises, unless nominal interest rates rise simultaneously alongside the inflation rate.

9. Write short notes on:-

a. Foreign Exchange Market

The foreign exchange market (also known as forex, FX, or the currencies market) is an over-the-counter (OTC) global marketplace that determines the exchange rate for currencies around the world. Participants in these markets can buy, sell, exchange, and speculate on the relative exchange rates of various currency pairs.
Foreign exchange markets are made up of banks, forex dealers, commercial companies, central banks, investment management firms, hedge funds, retail forex dealers, and investors.

b. Interest Rate Parity

Upar hai

c. Fisher Effect

Upar hai

Part 2 Foreign Exchange Risk

1. Give the uses of Currency Derivatives.

- **Hedging:** By importers/exporters and other hedgers(Hedging strategies are used by investors to reduce their exposure to risk in the event that an asset in their portfolio is subject to a sudden price decline.) Hedging protects the trader from foreign currency exposure and reduces losses by using currency derivatives. It also helps exporters and importers to generate profits or cover up losses during currency fluctuations.
- **Speculating:** By speculative traders(In finance, speculation is the purchase of an asset (a commodity, goods, or real estate) with the hope that it will become more valuable shortly)
- **Arbitraging:** By arbitrage traders(Arbitrage occurs when an investor can make a profit from simultaneously buying and selling a commodity in two different markets.)

2. What Is Quote Currency?

The quote currency in foreign exchange is the standard used to measure the value of a base currency. That is, the value of the first currency in a currency pair is quoted against the value of the second one, which is the quote or counter currency.

The quote currency is the second currency listed in a forex pair. It is also known as the counter currency. The price of a forex pair reflects how much it costs to purchase one unit of the base currency by selling the quote currency.

3. What is Triangular Arbitrage?

As per the definition, when there is a possible advantage in arbitrage in the foreign currency exchange, this arbitrage opportunity between three currencies is known as triangular arbitrage. Such a price difference is often a result of one overvalued market and another undervalued one.

The trader makes three simultaneous deals, purchasing one currency and selling another, with the base currency being the third one. Why? When there are differences between the rate of exchange and the quoted cross-currency rate, it develops an arbitrage opportunity. This scenario may arise when a currency is overvalued against one currency but undervalued against another.

In triangular arbitrage, an investor would trade at minimum transactional costs by converting an amount at one rate (EUR/USD), thereafter converting at another rate (EUR/GBP), and lastly to the original (USD/GBP)

4. Types of Foreign Exchange Exposure.

1. Transaction exposure
Transaction exposure is the most basic type of foreign exchange exposure and is associated with business transactions in foreign currency. The exposure may arise due to the time it takes from an entitlement to receive money from a customer and the actual date of the money's delivery. It may also arise during the time between placing a purchase order and settling the invoice.

2. Translation exposure
Translation forex exposure refers to the translation of a foreign subsidiary's financial statements, such as a balance sheet, from the local currency to the parent company's reporting currency. This may arise because of the parent company's reporting obligations to shareholders and regulators. Those obligations require the company to submit a consolidated set of accounts in the reporting currency for all the subsidiaries.

3. Economic or operating exposure
Economic forex exposure arises from the effect that unexpected currency fluctuations have on market value and future cash flows. Economic exposure is usually long-term and for this reason, may affect your long-term strategies.

5. Write short notes on:-

a. Currency derivatives

Currency derivatives are contracts to buy or sell currencies at a future date. The major types of currency derivatives are forward contracts, futures contracts, options, and swaps.

Despite having an average daily turnover of Rs 44,859 crores, currency derivatives in India are largely unknown to small retail investors.

The currency derivatives trading segment in India is dominated by importers, exporters, central banks, banks, and corporations.

b. Quote Currency

Upar hai

c. Triangular Arbitrage

Upar hai

1) The foreign exchange market

A) is organized as an over-the-counter market in which several hundred dealers stand ready to buy and sell deposits denominated in foreign currencies.
B) is very competitive.
C) functions no differently from a centralized market.
D) all of the above.

2) Flexible exchange rate system is also known as
a) Pegging exchange rate system
b) Floating exchange rate system
c) Dirty floating
d) Both (b) and (c)

3) In which system of exchange rate, the exchange rate does not change continuously?
a) Fixed exchange rate
b) Flexible exchange rate
c) Managed floating exchange rate
d) None of the above

4) Which of the following are the buyers and sellers of foreign exchange?
a) Individual and firms
b) Foreign exchange brokers
c) Commercial and central bank
d) All of the above

5) Fixed exchange rate is fixed by the Government in terms of ____.
a) Currency
b) Gold Reserves
c) Fixed assets
d) All of the above

6) "Managed floating exchange rate is also called dirty floating exchange rate, because".
a) A country uses it against other countries for self interest
b) Government has to hold huge reserves of foreign exchange
c) Both (a) and (b)
d) None of the above

7) What role does the Central Bank play in Foreign Exchange Market?
   a) Provides financial assistance
   b) Stabilizes the value of domestic currency

8) Both appreciation and depreciation occurs under (choose the correct alternative)
   a) Managed floating exchange rate
   b) Fixed exchange rate
   c) Flexible exchange rate
   d) None of the above

9) When the value of the British pound changes from $1.50 to $1.25, the pound has ________ and the dollar has ________.
   A) appreciated; appreciated
   B) depreciated; appreciated
   C) appreciated; depreciated
   D) depreciated; depreciated