Foreign Exchange Market

Meaning

- A foreign exchange rate is simply the price of one currency in terms of another.
- The foreign exchange market (forex or FX market) is a global decentralized market for trading currencies.
- Foreign exchange market is described as an OTC (Over the counter) market as there is no physical place where the participants meet to execute their deals.
- This market determines foreign exchange rates for every currency.
- Its primary purpose is to facilitate international trade and investment by allowing businesses to convert one currency to another.

Currency Name

1 USD = 0.85 EUR (Euro)
1 USD = 113 JPY (Japanese Yen)
1 USD = 0.75 GBP (British Pound)
1 USD = 1.28 CAD (Canadian Dollar)
1 USD = 1.36 AUD (Australian Dollar)
1 USD ≈ 113 Japanese Yen
1 USD ≈ 6.35 Chinese Yuan
1 USD ≈ 1,170 South Korean Won
1 USD ≈ 83 Indian Rupees
1 USD ≈ 1.35 Singapore Dollars
1 USD ≈ 7.78 Hong Kong Dollars

Key Features

1. **Decentralization:** The FX market operates globally without a central exchange. It's a network of banks, financial institutions, brokers, and traders dealing directly with one another.
2. **Liquidity:** It's one of the most liquid markets globally due to its immense size and continuous operation, enabling swift execution of trades.
3. **Trading 24/7 (24/5):** The market is open 24 hours a day, seven days a week, across different time zones.

Key Features

4. **Currency Pairs:** Currencies are traded in pairs (e.g., EUR/USD, USD/JPY). The exchange rate represents how much of one currency is needed to purchase another.
5. **Market Participants:** Various entities participate in the forex market, including central banks, financial institutions, multinational corporations, governments, speculators, and individual traders.
6. **Influence of Various Factors:** Exchange rates are influenced by multiple factors, including economic indicators, geopolitical events, interest rates, inflation, market speculation, and global economic performance.

Key Features

7. **Global Connectivity:** The market is accessible to traders worldwide, and technological advancements have made it easier for individuals and businesses to participate, regardless of their geographical location.

Instrument of Foreign Payment

1. **Bill of Exchange:** It's a written order issued by the exporter to the importer, demanding payment after a specified period.

2. **Bank Drafts:** These are like personal checks but issued by a bank.

3. **Letters of Credit (LC):** It's a guarantee provided by a bank on behalf of the importer (buyer) to the exporter (seller), ensuring that payment will be made once the exporter fulfills the terms and conditions specified in the letter of credit.
4. **Telegraphic Transfer (TT)**: This involves electronically sending money from the payer's bank account to the payee's bank account, often used for international payments.

Payment Method

5. **SWIFT (Society for Worldwide Interbank Financial Telecommunication):**
6. **Payment Cards (Credit/Debit):**
7. **International Money Orders:**
8. **Electronic Payment Systems:** Services like PayPal, TransferWise, and other online payment systems

Type of Foreign Exchange Market

- **Retail Market:** Individual of Firms can buy and sell forwign currency (mostly through banking services)

- **Interbank Market:** The interbank market involves large banks trading currencies amongst themselves. It's a wholesale market where significant volumes of currency trading occur.

Function of Foregn Exchange Market

- **Facilitating Currency Conversion**: One of the fundamental functions of the forex market is to enable the conversion of one currency into another.
- **Determining Exchange Rates:** The foreign exchange market plays a pivotal role in determining exchange rates. These rates fluctuate based on supply and demand dynamics, economic indicators, geopolitical events, and other factors.
- **Providing Liquidity:** The forex market is highly liquid, offering ample opportunities for buying and selling currencies.
- **Credit Function:** To provide credit, both international and national, to promote foreign trade. Bill of exchange have maturity period of three months, so credit required in that period.
- **Risk Hedging:** Participants use the foreign exchange market to manage and mitigate currency risk.

Function of Foregn Exchange Market

- **Speculation and Investment:** The forex market allows participants to speculate on currency movements. Traders and investors can capitalize on price changes to make profits or diversify their investment portfolios by trading in various currencies.
- **Central Bank Interventions:** Central banks play a significant role in the foreign exchange market. They intervene by buying or selling their own currency to stabilize exchange rates or achieve specific economic objectives.
- **Information Transmission:** The forex market acts as a valuable source of information. Exchange rate movements often reflect economic and geopolitical conditions. Participants use this information to make economic decisions, and policymakers use it as a gauge for economic health.

Exchange rate regimes and INR/USD nominal exchange rate

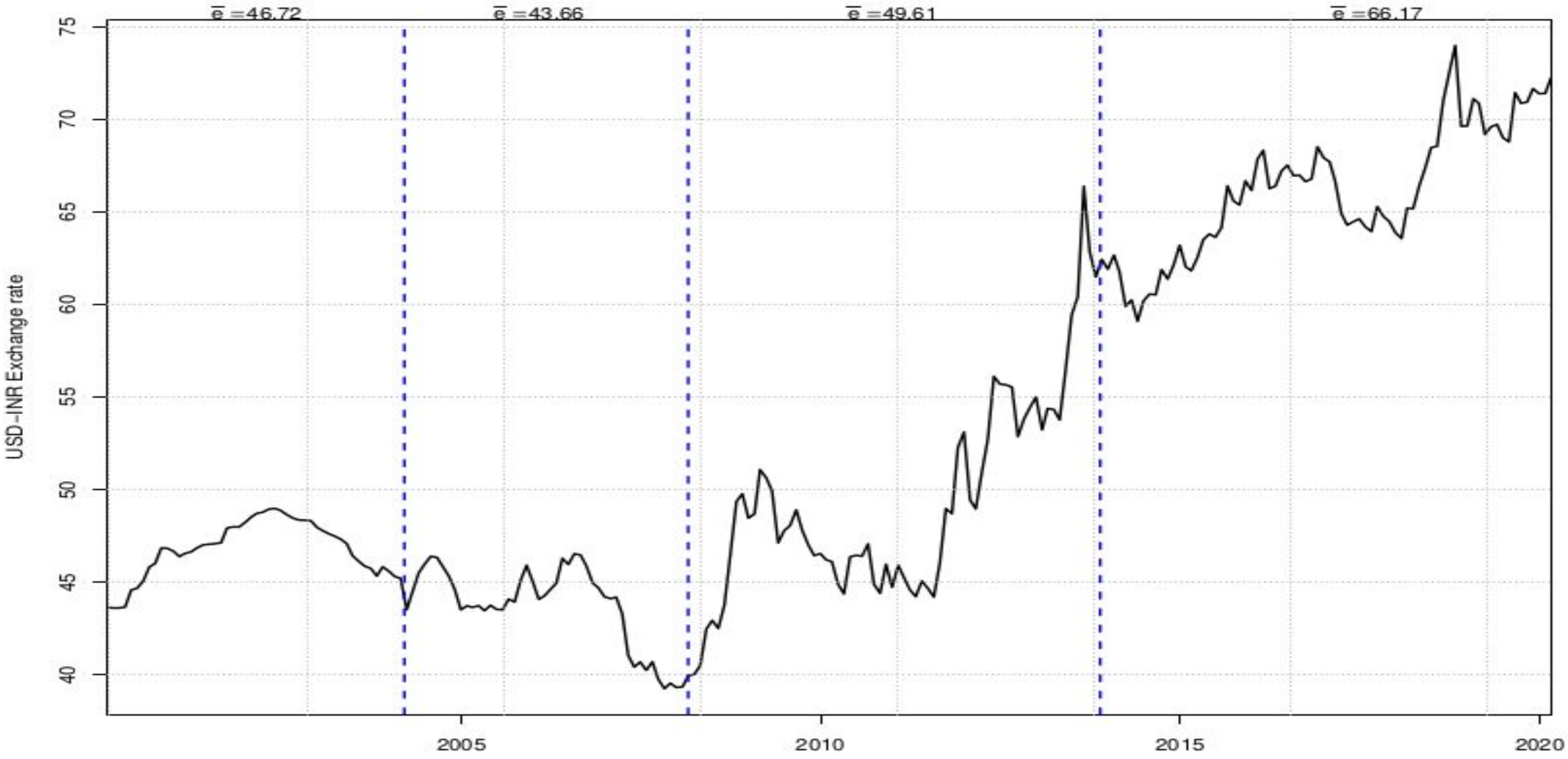
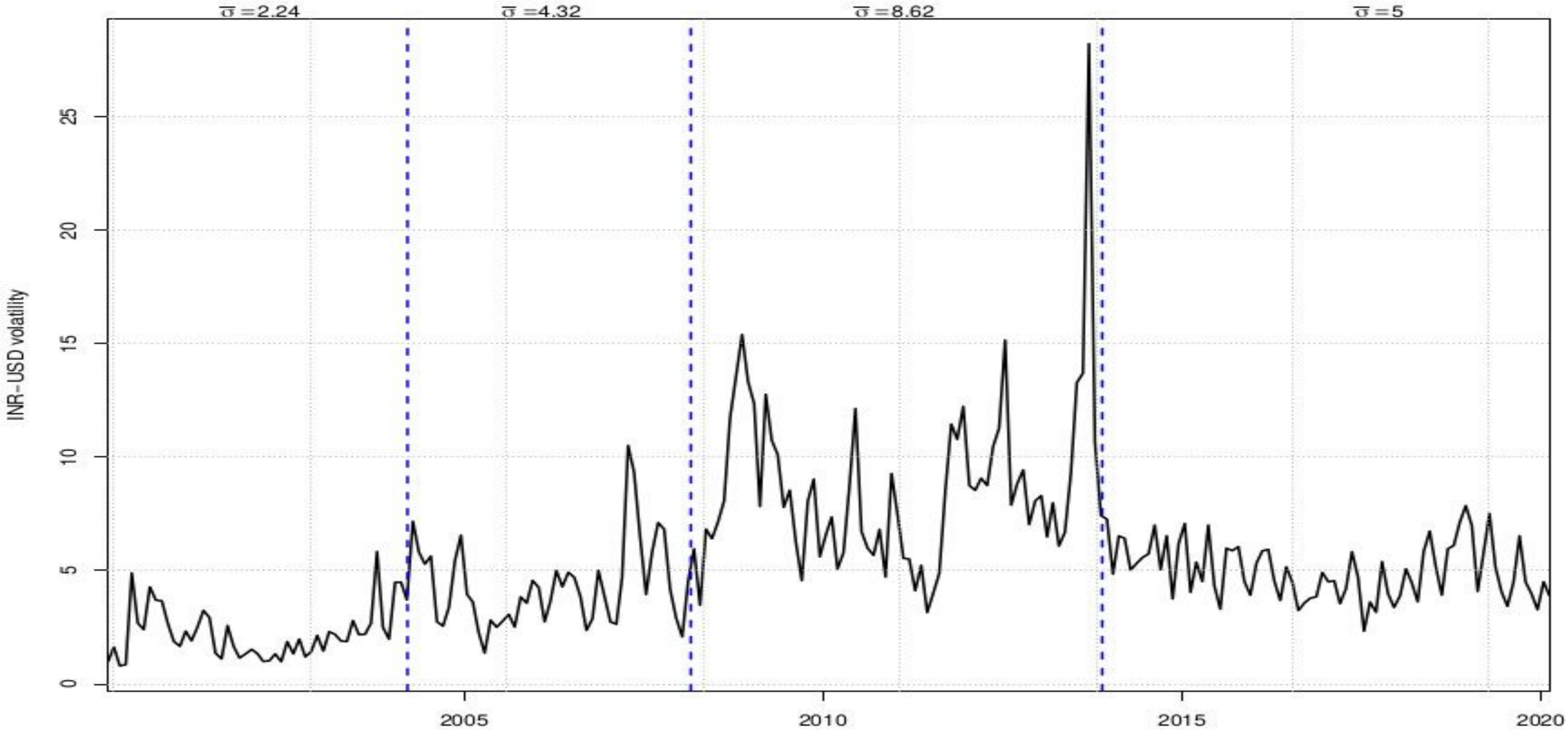
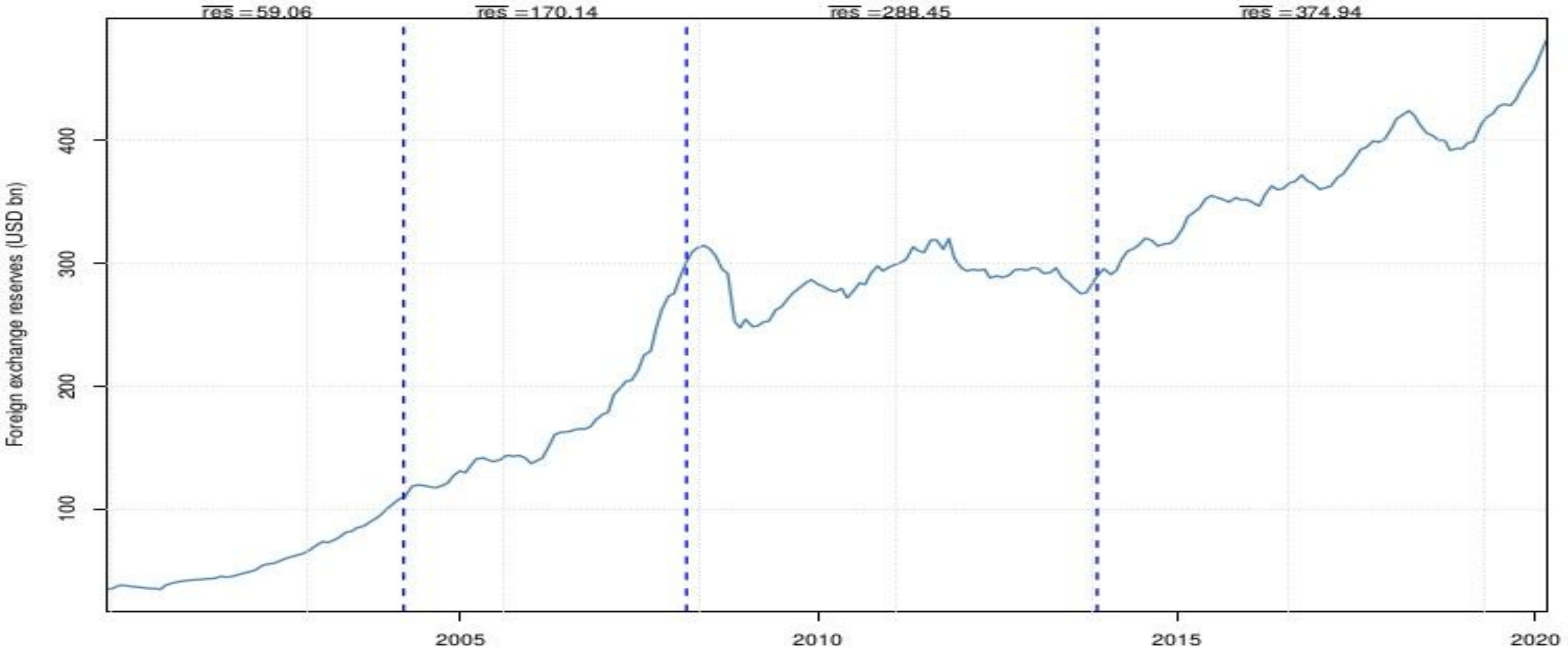


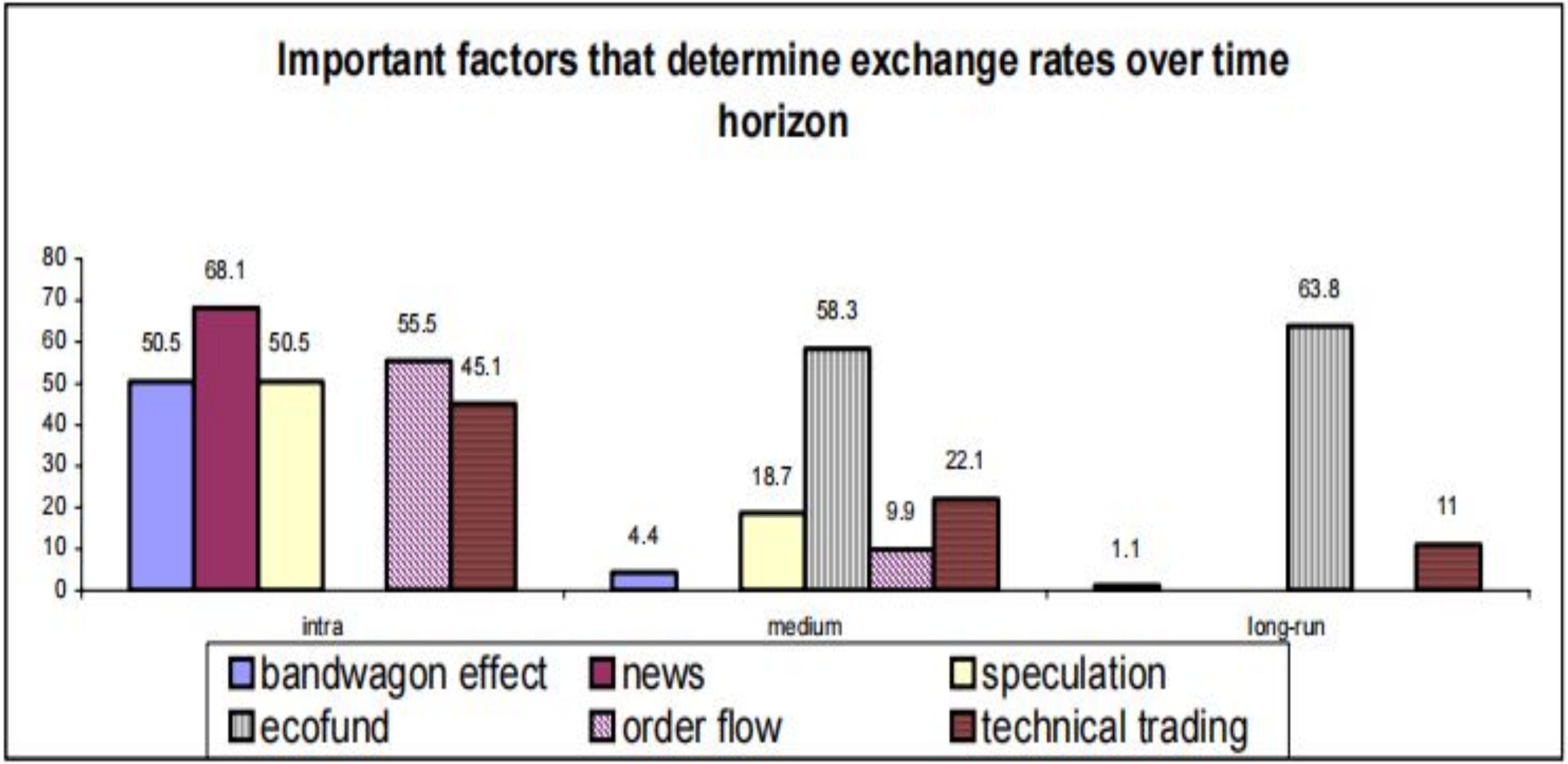
Figure 1: Exchange rate regimes and Volatility of INR/USD exchange rate



Exchange rate regimes and Foreign exchange reserves



Important factors that determine exchange rates



Foreign Exchange Market and World economic Power

- Today the U.S. dollar is the dominant international currency, serving as a unit of account, medium of exchange, and store of value not only for domestic transactions but also for private and official international transactions.
- The U.S. dollar replaced the British pound sterling after World War II as the dominant vehicle currency because of its more stable value, the existence of large and well-developed financial markets in the United States, and the very large size of the U.S. economy.
- Since its creation at the beginning of 1999, the euro (the common currency of 19 of the 28-member countries of the European Union) has become the second most important vehicle international currency.