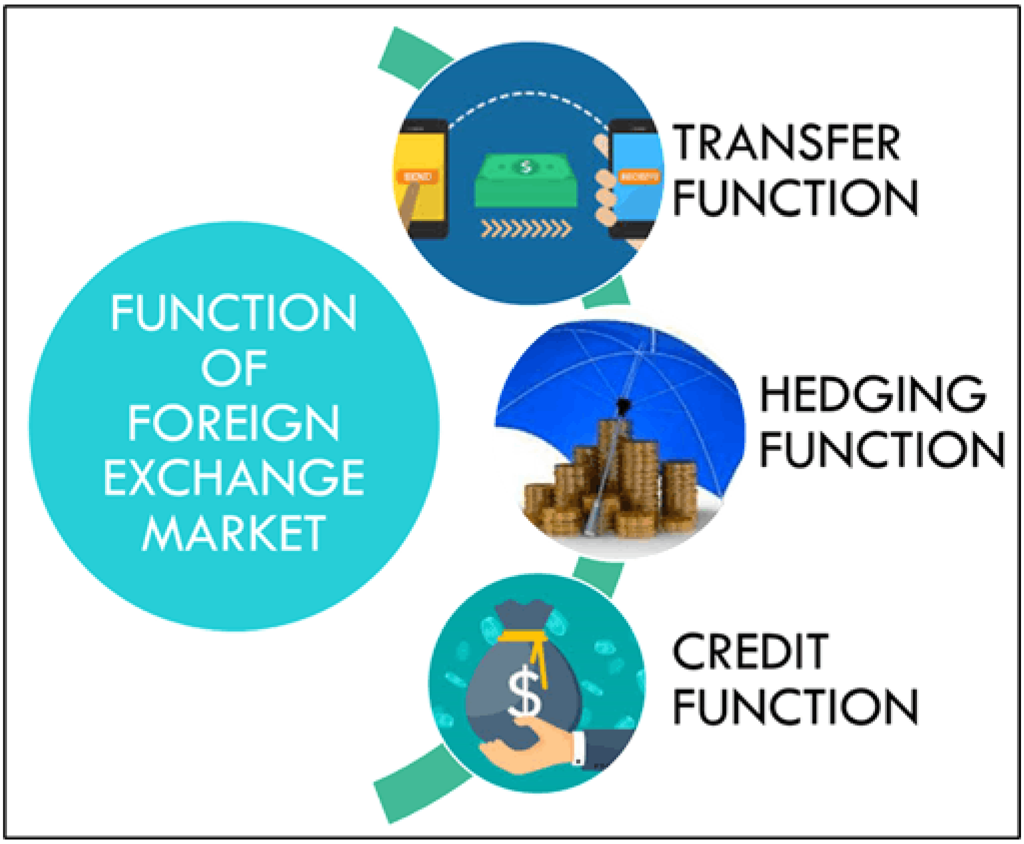
Examrace

Foreign Exchange Markets: Transfer, Credit and Hedging Function

Foreign Exchange Markets

- The foreign exchange market is the market in which individuals, firms, and banks buy and sell foreign currencies or foreign exchange.
- The foreign exchange market for any currency — say, the Canadian dollar — could be at any location (such as London, Paris, Singapore, Tokyo, and New York) where dollars are bought and sold for other currencies.
- These different monetary centers are connected electronically and are in constant contact with one another, thus forming a single international foreign exchange market.
- It enables tourists, governments, investors, brokers, commercial banks to get hold of foreign currency.



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Transfer Function

- It enables transfer of funds or purchasing power from one nation and currency to another. Credit instruments like bills of exchange, bank drafts and telephonic transfers helps in completing these transactions.
- It is accomplished by an electronic transfer and increasingly through the Internet.

- For e. g. a domestic bank will instructs its correspondent bank in a U. S. A. to pay a specified amount of the local currency to a person, firm, or account.

Credit Function

- It has enabled Exports-Imports. As it extends Credit facility.
- Bills of exchange, with maturity period of three months, are used for international payments.
- Credit is required so that importer can get time to take possession of goods, sell them and obtain money to pay off the bill.

Hedging Function

- Widely practices and ensures that losses are less.
- In Hedging, an agreement is entered to supply the goods at a specified date, specified exchange rate. It ensures that exchange rate volatility does not affect the transaction.
- The purpose of hedging is to avoid losses that might be caused due to exchange rate variations in the future.
- For e. g. 1 Ton of wheat at Current exchange rate will cost ₹ 3000. The same ton of Wheat after 1 month will cost ₹ 4000 due to exchange rate volatility. So, the importer will enter in contract with the exporter to supply 1 ton of wheat after 1 month at say ₹ 3300.

Participants in Foreign Exchange Market

- Traditional users as tourists, importers, exporters, investors, and so on. These are the immediate users and suppliers of foreign currencies.
- At the next, or second, level are the commercial banks, which act as clearinghouses between users and earners of foreign exchange.
- At the third level are foreign exchange brokers, through whom the nation’s commercial banks even out their foreign exchange inflows and outflows among themselves (the so-called interbank or wholesale market) .
- Finally, at the fourth and highest level is the nation’s central bank, which acts as the seller or buyer of last resort when the nation’s total foreign exchange earnings and expenditures are unequal.

Foreign Exchange Rates: Spot and Forward Rates

Spot Rate

- Spot Rate is the Current rate of exchange. This type of transaction is called a spot transaction, and the exchange rate at which the transaction takes place is called the spot rate.

- Here the transaction takes place as soon as delivery takes place.

Forward Rate

- A forward transaction involves an agreement today to buy or sell a specified amount of a foreign currency at a specified future date at a rate agreed upon today (the forward rate) .
- For example, I could enter into an agreement today to purchase $ 100 6 months from today at $ 1 = ₹ 64. Note that no currencies are paid out at the time the contract is signed except the security margin. After 6 months, I get the $ 100 for ₹ 64, regardless of what the spot rate is at that time.

Arbitrage

- The exchange rate between any two currencies is kept the same in different monetary centers by arbitrage.
- The arbitragers purchase the currency in the market where it is cheaper, for immediate resale in the market where it is more expensive, to make a profit.
- For example, if the dollar price of the Rupee was $ 1 = ₹ 66 in New York and $ 1 = ₹ 65 in Mumbai, an arbitrageur (usually a foreign exchange dealer of a commercial bank) would purchase $ at ₹ 65 in Mumbai and immediately resell them in New York for ₹ 66, thus realizing a profit of Re 1 per $.

MCQ

Q. 1. Who maintains the foreign exchange reserves in India?

(a) Reserve Bank of India

(b) State Bank of India

(c) Ministry of Finance, Government of India

(d) Export-Import Bank of India

Ans: (a)

Q. 2. With reference to Exchange rate, consider the following statements:

1. Managed floating exchange rate system is a mixture of a flexible exchange rate system and a fixed rate system. 2. In dirty floating, central banks intervene to buy and sell foreign currencies to moderate exchange rate movements whenever they feel that such actions are appropriate.

Select the correct answer using the code given below.

(a) 1 only

(b) 2 only

(c) Both 1 and 2

(d) Neither 1 nor 2

Ans: (c)

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