Foreign Exchange Market and Exchange Rate

Meaning

The Foreign Exchange Market is a market where the buyers and sellers are involved in the sale and purchase of foreign currencies. In other words, a market where the currencies of different countries are bought and sold is called a foreign exchange market. The rate at which one currency is exchanged for another is called the rate of exchange. The rate of exchange is the price of one currency stated in terms of another currency. For example, if one U.S. dollar exchanges for 15 Indian rupees, then the rate of exchange is $ 1= Rs.15 or Re.1 = 1/15 = .66 dollars. It means that what $1 can purchase in America, Rs. 15 can purchase in India. In other words, the rate of exchange expresses the external purchasing power of a home currency.

The Foreign Exchange Market is a type of financial institution which performs following functions:

(a) Liquidation of international currencies;

(b) For certain currency determines exchange rates;

(c) For international trades and reserves, sets auctions

Features of Foreign Exchange Market

Foreign exchange markets have the characteristics of their own, which is required to be identified. The features of the Foreign Exchange Market are as follows:

1. High Liquidity: The foreign exchange market is the most easily liquefiable financial market in the whole world. This involves the trading of various currencies worldwide. The traders in this market are free to buy or sell the currencies anytime as per their own choice.

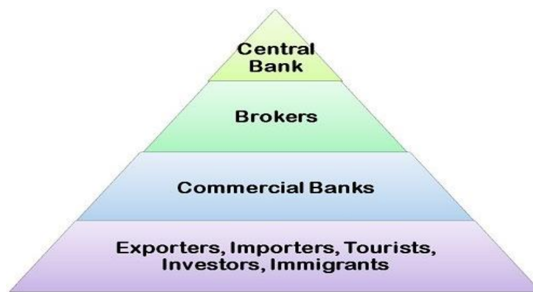
2. Market Transparency: There is much clarity in this market. The traders in the foreign exchange market have full access to all market data and information. This will help to monitor different countries' currency price fluctuations through the real-time portfolio.

3. Dynamic Market: The foreign exchange market is a dynamic market structure. In these markets, the currency values change every second and hour.

4. Operates 24 Hours: The Foreign exchange markets function 24 hours a day. This provides the traders the possibility to trade at any time

Structure or Participants of Foreign Exchange Market

The structure or Participants of the foreign exchange market constitutes central banks, commercial banks, brokers, exporters and importers, immigrants, investors, tourists. These are the main players of the foreign market, their position and place are shown in the figure below:



As shown in the above figure,

1) At the bottom of a pyramid are the actual buyers and sellers of the foreign currencies- exporters, importers, tourist, investors, and immigrants. They are actual users of the currencies and approach commercial banks to buy it.

2) The commercial banks are the second most important organ of the foreign exchange market. They function as clearing houses, thereby helping in wiping out the difference between the demand for and the supply of currencies. These banks buy the currencies from the brokers and sell it to the buyers.

3) The third layer of a pyramid constitutes the foreign exchange brokers. These brokers function as a link between the central bank and the commercial banks and also between the actual buyers and commercial banks. They are the major source of market information. These are the persons who do not themselves buy the foreign currency, but rather strike a deal between the buyer and the seller on a commission basis.

4) The central bank of any country is the apex body in the organization of the exchange market. They work as the lender of the last resort and the custodian of foreign exchange of the country. The central bank has the power to regulate and control the foreign exchange market so as to assure that it works in the orderly fashion. One of the major functions of the central bank is to prevent the aggressive fluctuations in the foreign exchange market, if necessary, by direct intervention.

Functions of Foreign Exchange Market

The various functions of the Foreign Exchange Market are as follows:

1) Transfer Function: The basic and the most obvious function of the foreign exchange market is to transfer the funds or the foreign currencies from one country to another for settling their payments. The market basically converts one’s currency to another.

2) Credit Function: The FOREX provides short-term credit to the importers in order to facilitate the smooth flow of goods and services from various countries. The importer can use his own credit to finance foreign purchases.

3. Hedging Function: A third function of the foreign exchange market is to hedge foreign exchange risks. Hedging means the avoidance of a foreign exchange risk. In a free exchange market when exchange rate, i. e., the price of one currency in terms of another currency, change, there may be a gain or loss to the party concerned. Under this condition, a person or a firm undertakes a great exchange risk if there are huge amounts of net claims or net liabilities which are to be met in foreign money.Exchange risk as such should be avoided or reduced. For this the exchange market provides facilities for hedging anticipated or actual claims or liabilities through forward contracts in exchange. A forward contract which is normally for three months is a contract to buy or sell foreign exchange against another currency at some fixed date in the future at a price agreed upon now.

Types of exchange rates in Foreign Exchange Market

The Foreign Exchange Market has its own varieties and has different rates of Exchange which are as follow:

1) Spot rate: A spot foreign exchange rate is the rate of a foreign exchange contract for immediate delivery (usually within two days). Spot rate of exchange is the rate at which foreign exchange is made available on the spot. It is also known as cable rate or telegraphic transfer rate because at this rate cable or telegraphic sale and purchase of foreign exchange can be arranged immediately. Spot rate is the day-to-day rate of exchange. The spot rate is quoted differently for buyers and sellers. For example, $ 1= Rs 15.50 for buyers and $ 1= Rs 15.30 for the seller. This difference is due to the transport charges, insurance charges, dealer’s commission, etc. These costs are to be born by the buyers.

2) Forward Foreign Exchange: A forward foreign exchange is a contract to purchase or sell a set amount of a foreign currency at a specified price for settlement at a predetermined future date (closed forward) or within a range of dates in the future (open forward). Forward rate of exchange is the rate at which the future contract for foreign currency is made. The forward exchange rate is settled now but the actual sale and purchase of foreign exchange occurs in future. The forward rate is quoted at a premium or discount over the spot rate. Thus, the forward rate refers to the future exchange rate agreed upon in forward contracts.