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FOREIGN EXHANGE MARKETS AND DEALINGS

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ABSTRACT

Different countries have different currencies and the settlement of all business transactions within a country is required/preferred in the local currency. The foreign exchange (FE) where the currency of one country is traded for the currency market provides a forum another country FE markets deal with a large volume of funds as well as a large number of currencies of various countries. The major of markets are London, New York and Tokyo and the major currencies traded are the US dollar, British pound sterling, Euro, French franc, Japanese yen, of Deutsche mark, and Swiss franc. Commercial banks and central banks of the countries are the major participants in the FE markets. Business firms normally buy and sell securities through authorized dealers, say, commercial banks or brokers, While the commercial banks and other participants in the FE markets operate on commercial principles, the operations of the central banks are primarily regulatory in nature. Different currencies have different values: they are traded at an exchange rate. An exchange rate is the price of one country's currency expressed in terms of the currency of another country Foreign exchange rate/quotation can either be direct or indirect. It is said to be direct when it is expressed in a manner that reflects the exchange of a specified number of domestic currency (say, Rs 48) for one unit of foreign currency (say, US $). The FE quotation is indirect when it is quoted in a manner that reflects the exchange of a specified number of foreign currency (say, US $0.02083) for one unit of local currency (say 1 rupee). Direct quotations are known as European quotation and indirect quotations as American There are two-way rates for the FE quotations, one for buying the foreign currency (bid price) and another for its selling (ask price). Since dealers expect profit in foreign exchange operations, the bid price is lower than the ask price, The FE quotations are always with respect to the dealer. By convention, the first rate is the buying rate and the second rate is the selling rate (say Rs 47.50 Quotations, in practice, are up to four decimal points. Rs. 48.00 for US $1. Spread is the difference between the bid price and the ask price. It is gross profit of a dealer, out of which it meets its business/establishment expenses while spot exchange rates are applicable to the purchase and sale of foreign exchange on an immediate delivery basis (in practice delivery takes place two days later), the forward exchange rates are applicable for the delivery of foreign exchange at a future date sayafter 1 month/3 months/6 months and so on).

KEYWORDS: *Foreign Exchange (FE), Local Currency, Direct Quotations, Bid Price, Ask Price.*

Introduction

There is a growing tendency among business firms to operate in other countries. They set up their factories/subsidiaries abroad to seek new markets and develop products to cater to the needs and requirements of foreign markets; they raise capital from many countries. Being so, it is imperative for finance managers, in particular, and other managers, in general, to understand the processes and methods of dealings in foreign exchange markets. This also deals with the modus *operandi* of foreign exchange transactions in foreign exchange markets.

Foreign Exchange Markets

Different countries have different currencies and the settlement of all business transactions within a country is done/preferred in the local currency. The foreign exchange market provides a forum where the currency of one country is traded for the currency of another country. Suppose Air India has signed an agreement to buy/import aircrafts from an US based firm. Air India has to pay the US firm in

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American dollars. To do so, Air India has to purchase US dollars ($) in the foreign exchange market and pay the US firm. In case Air India buys aircrafts from a French firm, it would be required to purchase French francs (FD from the foreign exchange market to make the payment. Thus, the requirement of foreign currency of the importer (Air India) hinges upon which country the imports are made from and/or the currency preferred by the exporter. While domestic currency is preferred by the exporters, in general, they may be willing to deal in the major currencies (also referred to as 'hard' currencies) of the world. Included in this category are the US dollar (US $), the British pound sterling (), euro (€), the French franc (Ff), the Japanese yen (¥), the Deutsche mark (DM), and the Swiss franc (S). Apart from the payment of imports, foreign currency requirements may be traced to foreign direct investment and lending also.

Foreign exchange (FE) markets deal with a large volume of funds as well as a large number of currencies (belonging to various countries). For this reason, they are not only worldwide markets but also the world's largest financial markets. Though there are foreign exchange markets in virtually all countries, London, New York and Tokyo are the nerve centers of foreign exchange activity. The large commercial/investment banks and central banks of the countries are the principal participants in the FE markets. In general, business firms do not operate on their own they normally buy and sell currencies through a commercial bank. Likewise, as a strategy commercial banks may sometimes engage/prefer the services of individual brokers to hide their identity as they apprehend that the disclosure of their names may unfavorably influence short term quotes. For the same reason, importers, needing a large volume of funds may like to deal through brokers/commercial banks.

While the primary objective of commercial banks, investment bankers and brokers in dealing FF markets is commercial in nature, whether they deal on their own account or for their clients, the central bank's operations (say, in the case of India, the Reserve Bank of India) in the market are regulatory in nature. To put it differently, the principal central bank of the country intervenes in the FE market primarily to regulate the volatility of foreign exchange rates. Obviously, the objective of their operations in the FE markets is not to make profits. They intend to maintain the exchange rate of the domestic country in tune with the requirements of the national economy and Government policy. They intend to avoid a sudden appreciation or depreciation of the domestic currency as it may be against the interest of the domestic economy. This is achieved through the buying and selling of the foreign currency by the central bank of the country: For instance, the Reserve Bank of India, on many occasions in recent years, has sold US $ to augment their supply with a view to prevent a continuous decline in the value of Indian rupee vis-a-vis US $: likewise. It has purchased US $ many a time weaken the Indian rupee, with a view to promote exports.

Most of the trading in the FE markets take place in the 'major currencies stated earlier. All these currencies are fully convertible. There is an active market for these currencies in terms of the presence of a large number of buyers and sellers willing to execute foreign exchange dealings inthese currencies: foreign exchange dealings primarily take place through telephone and fax messages. Therefore, the geographical existence of the foreign exchange market does not have much relevance.

Foreign Exchange Dealings

Foreign exchange dealings-in tem of various types of exchange rates (spot forward and cross), direct and indirect quotations and spread and arbitrage process to realize profits in the case of mis-alignment of exchange rates.

Exchange Rates

Different countries have different currencies and the different currencies have different values evidently, there is a need for rules for currency conversion for global business and investments the rate of conversion is the exchange rate. In other words, an exchange rate is the price of one country's currency expressed in terms of the currency of another country. For instance, a rate of Rs 48 per US S implies that one US dollar cost Rs 48. To put it differently, US $0.02083 costs one rupee as 1/48 = $0.02083. Thus, there are two quotes: Indian Rs 48 = US $1 (Direct quote) and GD US $0.02083 - Indian Re 1 (Indirect quote). Both quotations reflect the same exchange conversion rate and are reciprocal to each other.

Direct and Indirect Quotations

A foreign exchange (FE) quotation can either be direct or indirect. An FE quotation is said to be direct when it is quoted/expressed in a manner that reflects the exchange of a specified number of domestic currency vis-a-vis unit of foreign currency. In our preceding example, Rs 48 = US $1 is a direct quotation for US $ in India. Likewise, Rs 7680= British pound sterling £1, Rs 50.55 = Euro €1. R$ 6.80 = French franc, (FD= are direct FE quotes in India in that they indicate Rs 76.80, Rs 50.55 and Rs 6.80 are required to exchange one unit of & €l and FT H respectively. The FE quotation is indirect when it is quoted in a manner that reflects the exchange of a specified number of foreign currency vis-à-vis 1 unit of local currency. In the above example, US $0.02083 = Re 1 is an indirect quotation in India. Likewise, £0.01302 = Re 1, €0.01978 = Re 1. F 01470 Re 1 are examples of indirect quotations in India.

Direct quotations are known as European quotations and indirect quotations as American quotations direct quotations are easier to comprehend and are, hence, followed by a large number of countries, including India.

Two-way Quotations/Rate

The FED rates explained above are single quote/rate. In practice, liars quotes two-way rates, one for buying the foreign currency (known as bid price rate) and another for selling the foreign currency (referred to as ask price rate). Since dealers expect profit in foreign exchange operations, the two prices obviously cannot be the same. Evidently, the dealer will buy the foreign currency at a lower rate and sell the foreign currency at a higher rate. For this on the bid quote is at a lower rate and the 'ask' quote is a higher rate. The quotations are always with respect to the dealer.

The foreign exchange quotations contain two rates. By convention, the buying rate follows the selling rate, that is the first rate is the buying rate and selling rate is the second rate. For example, when a dealer in Bombay quotes pound sterling 1 = R$ 78,00 - Rs 78.15, it implies that the dealer is prepared to buy British pound sterling at Rs 78 and sell it at Rs 78.15. Though we have taken the quote up to 2 decimal points, quotations in practice are normally made up to four decimal points for mast of the currencies.

Spread

Spread is the difference between the ask price and the bid price. The spread is affected by a number of factors. The currency involved, the volume of business and the market sentiments rumors about the currency are the major variables reckoned by dealer's operators in the foreign exchange market. In case the currency involved is subject to higher volatility (say, the US $ in February March 2003, on account of the US threat of war on Iraq), the dealer will obviously like to have a higher spread in his quote to compensate for the higher risk he assumes in such circumstances.

Spread to the dealer is akin to the gross profit for a business firm out of which he is to meet establishment expenses. In percentage terms, spread can be expressed in terms.

Spread (per cent) = Ask price Bid price Ask price x 100

Spread (per cent) = Ask price - Bid price is price] x 100

In the above example of the £ spread per cent is 0.19193, that is [(Rs. 78.15 – Rs 78.00) / Rs. 78,151] * 100, when it is determined with reference to the ask price

Prima facie, the spread (percentage appear to be very low Since the volume of time Solved is substantial, the total gross return to the dealer In absolute terms may vary sractive. Continuing with 0.19193 spread, if the dealer has a turnover of Rs 100 million in a day, his gross spread will be Rs 191,930, that is, 0.19193 x Rs 100 million) / 100.

Spot Rates and Forward Rates

In discussing exchange rales, is important to distinguish between spot exchange rates and forward exchange rates. Spot exchange rates are applicable to purchase and sale of foreign exchange on an immediate delivery basis. Though the term immediate an impression of instantaneous delivery in practice, delivery actually takes place to days later. Suppose Air India has bought aircrafts. t is to convert Indian rupees into s om (depending on which country aircrafts have been bought from In case the terms of payment are Immediate, Air India is to arrange the spontaneous purchase of the round Mum of US at the spot rate from the spot market. The spot rate the rate of day on which the action skin the spot rate prevailing at that point of time, and then remit the payment to the US firm. Second, Air India may wish to avoid the uncertainty of the exchange rate three months from now. In that Case, Air India is topurchase the required US 5 in the forward market forward exchange rate that is decided at the time of the agreement. The agreed forward rate is valid for eighteen place, though the execution of transaction occurs within a maximum of two working days In contrast, forward exchange rates are applicable for the delivery of foreign exchange at a future date. Air India is to make payment after 90 days, as per the credit term from the US firm has two options available. First, do nothing to arrange foreign exchange payment on the due date of payment after 3 months), make purchases of the due sum of US $ from the spot market, at irrespective of the actual spot rate on the date of the maturity of the forward contract (that 90 days from today in the case of Air India), The delivery of US S and the payment of Indian rupee takes place 90 days later, on the date of settlement Thus, Air India is eliminated change by entering into a forward contract.

The concept of forward rates is equally significant and relevant to the exporter/seller. The seller / exporter may will like/prefer to be sure of the export/sale proceeds. Suppose the Indianfirm sells goods of the value of US $10 million on 6 months credit. To eliminate the union the US S-rupee exchange rate, the Indian firm may enter into a contract of selling US six months from now.

On February 1, an Indian firm export goods of the value of US $100 million on 6 months February 1, the six-month forward rate is Rs 49 per US $. The firm agrees to sell US $10O million at R August 1 By entering into such a contract, the Indian firm has assured self of the receipt of US $16) x Rs 49) Rs 49900 million on, irrespective of the spot rate prevailing on that day. Suppose, the actual spot is Rs 4850 per US $ on August 1. The Indian firm has gained Rs 50 million (Rs 4,900 million actual minus Rs 4850 million that it otherwise would have obtained in absence of the forward rate cost. However, it should also be noted that the firm also runs the risk of potential loss in the event of the actual spot rate on tums out to be higher than Rs 49. Let us assume that the actual spot rate is Rs 1930 on August. The firm, in absence of the forward rate contract, would have received Rs 4,930 million (US $100 million x Rs 49 30), as a result, it would suffer a loss of Rs 30 million Rs 4,930 million - Rs 1900 million apparent from Example 1 that the forward rate contracts (which take place in the forward ticket eliminate exchange rate risk. The example also highlights that elimination is achieved at a cost in terms of the potential loss of less recipes in the case of forward sale transaction and money payments (in the case of forward purchase transaction. This happens when the actual spot rate on the date of settlement turns out to be unfavorable to the business firm hedging the risk In general, spot rates as well as forward rates have two way quotes that is the quotation contains both the buying rate and selling rate. Theoretically, forward rates can be for any number of months or even a fraction of a month. In practice, forward rates are normally quoted for one month, two months, three months, nine months and twelve months Finally, forward rates can be at a premium or discount. There is a very simple rule to ascertain whether the forward exchange rates are at a premium or discount. The rule requires the comparison of the spot rate and pound rate In case the forward rates are higher than the spot rate it implies that forward rates are at premium as more amount of domestic currency required to be paid in future to purchase y amount of foreign currency, On the contrary, the forward rates are lower than the spot rates, it signals that the forward rates are at discount in that less amount of domestic currency is required in future (to purchase amount of foreign currency). Forward rate premium or discount in annualized percentage) -2-uts spot rate can be computed.

$$\boldsymbol{Premium} = \frac{\text{Forward rate} - \text{Spot rate}}{\textit{Spot rate}} * \frac{12\ \textit{months}}{N}$$

$$\textit{Discount} = \frac{\text{Spot rate} - \text{Forward rate}}{\textit{Spot rate}} * \frac{12\ \textit{months}}{N}$$

Where N refers to the number of months for which the forward contract has been made.

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