DEPARTMENT OF COMMERCE AND FINANCIAL STUDIES
BHARATHIDASAN UNIVERSITY, TIRUCHIRAPPALLI – 620024
MBA (Financial Management)

Course Code: FMCC8/24

Course Name :FOREIGN EXCHANGE MANAGEMENT

Unit – I / Topic : Introduction to Currency Markets

Course Teacher: Dr. J.GAYATHRI

Email ID: gayajayapal@gmail.com

Scheme of Presentation

- History of foreign exchange markets
- Major currency pairs
- Overview of international currency markets
- Basics and Peculiarities of currency markets in India
- Settlement or value date
- Over-the-Counter (OTC) forward market
- Exchange rate arithmetic
- Cross rate
- Impact of market economics on currency prices
- Economic indicators.

Brief History of Foreign Exchange Markets

- The current currency rate mechanism has evolved over thousands of years
- Initially, the trading of goods and services was by barter system
- Barter system had its difficulties primarily because of non-divisibility of certain goods, cost in transporting such goods for trading and difficulty in valuing of services.
- Therefore the need to have a common medium of exchange resulted in the innovation of money.

Brief History of Foreign Exchange Markets

- People tried various commodities as the medium of exchange ranging from food items to metals.
- Amongst metals, gold and silver coins were most prominent and finally gold coins became the standard means of exchange.
- The process of evolution of medium of exchange further progressed into development of paper currency.
- With time, countries started trading across borders as they realized that everything cannot be produced in each country or cost of production of certain goods is cheaper in certain countries than others.
- The growth in international trade resulted in evolution of foreign exchange (FX) i.e., value of one currency of one country versus value of currency of other country

Brief History of Foreign Exchange Markets

- The smooth functioning of international trade required a universally accepted foreign currency to settle the internal trade and a way to balance the trade imbalances amongst countries.
- Different systems were tried in past to arrive at relative value of two currencies.
- 1870 countries agreed to value their currencies against value of currency of other country using gold as the benchmark for valuation.
- Central banks issue paper currency and hold equivalent amount of gold in their reserve.
- The value of each currency against another currency was derived from gold exchange rate.
- With further growth in international trade, changing political situations (world wars, civil wars, etc) and situations of deficit/ surplus on trade account forced countries to shift from gold standard to floating exchange rates.

Brief History of Foreign Exchange Markets

- In the floating exchange regime, central bank's intervention was a popular tool to manage the value of currency to maintain the trade competitiveness of the country.
- Central bank would either buy or sell the local currency depending on the desired direction and value of local currency.
- During 1944-1971, countries adopted a system called Bretton Woods System.
- This system was a blend of gold standard system and floating rate system.
- As part of the system, all currencies were pegged to USD at a fixed rate and USD value was pegged to gold.
- With adoption of this system, USD became the dominant currency of the world.

Brief History of Foreign Exchange Markets

- Finally Bretton Woods system was suspended and countries adopted system of free floating or managed float method of valuing the currency.
- Developed countries gradually moved to a market determined exchange rate and developing countries adopted either a system of pegged currency or a system of managed rate.
- Although in long run it is difficult to maintain the peg and ultimately the central bank may change the value of peg or move to a managed float or free float.
- In managed float, countries have controls on flow of capital and central bank intervention is a common tool to contain sharp volatility and direction of currency movement.

Major Currency Pairs

- The most traded currency pairs in the world are called the Majors.
- The list includes following currencies: Euro (EUR), US Dollar (USD), Japanese Yen (JPY), Pound Sterling (GBP), Australian Dollar (AUD), Canadian Dollar (CAD), and the Swiss Franc (CHF).
- These currencies follow free floating method of valuation.
- Amongst these currencies the most active currency pairs are: EURUSD, USDJPY, GBPUSD, AUDUSD, CADUSD and USDCHF.

US Dollar (USD)

- The US Dollar is by far the most widely traded currency.
- US Dollar reflects its substantial international role as
- “investment” currency in many capital markets,
- “reserve” currency held by many central banks,
- “transaction” currency in many international commodity markets,
- “invoice” currency in many contracts, and
- “intervention” currency employed by monetary authorities in market operations to influence their own exchange rates.
- vehicle currency greatly reduces the number of exchange rates that must be dealt with in a multilateral system.

EURO, Japanese Yen, British Pound, Swiss Franc

- Euro has a strong international presence and over the years has emerged as a premier currency, second only to the US Dollar.
- Japanese Yen (JPY) is the third most traded currency in the world.
- Until the end of World War II, the Pound was the currency of reference. The currency is heavily traded against the Euro and the US Dollar, but it has a spotty presence against other currencies.
- The Swiss Franc is the only currency of a major European country that belongs neither to the European Monetary Union nor to the G-7 countries. Although the Swiss economy is relatively small, the Swiss Franc is one of the major currencies, closely resembling the strength and quality of the Swiss economy and finance.

Overview of International Currency Markets

- For currency market, the concept of a 24-hour market has become a reality.
- In financial centers around the world, business hours overlap; as some centers close, others open and begin to trade.
- With access to all of the foreign exchange markets generally open to participants from all countries, and with vast amounts of market information transmitted simultaneously and almost instantly to dealers throughout the world, there is an enormous amount of cross-border foreign exchange trading among dealers as well as between dealers and their customers.

Basics of Currency Markets and Peculiarities in India

1 Currency pair

2 Base Currency / Quotation Currency

3 Interbank market and merchant market

4 Two way quotes

5 Appreciation / Depreciation

6 Market timing

7 Price benchmarks

8 Price discovery

9 RBI reference rate

Settlement Date (or) Value Date

- Unlike currency futures market, the settlement in the OTC spot market happens by actual delivery of currency.
- The mechanism of settlement where each counterparty exchange the goods traded on the maturity of contract is called as gross settlement and the mechanism where market participants only settle the difference in value of goods is called as net settlement.
- The most important value date is the “spot” value date, which is settlement after two business days.

Settlement Date (or) Value Date

- The most important value date is the “spot” value date, which is settlement after two business days.
- Any settlement date after spot value date is called “forward” value dates, which are standardized into 1-month, 2-month, etc after spot value date.
- The forward market can extend up to one year.
- For a currency pair for which spot date is at T+2 and if settlement happens on the trade date, the settlement price is called as “cash” rate and if happens one day after trade date, the price is called as “tom” rate.

OTC Forward Market

- The forward OTC market can provide quotes for booking a forward contract for any maturity.
- One more unique feature of OTC forward market is the requirement of underlying trade contract before executing the forward contract.
- According to RBI guidelines, any resident Indian desiring to book a forward contract should have an underlying trade contract which could establish exposure to foreign currency.
- The market participant is expected to submit the trade contract to bank within 15 days of booking the forward contract.
- It has also made provisions to facilitate booking of forward contracts by small and medium enterprises (SME) without submitting the underlying trade contracts.

Exchange rate arithmetic - cross rate

- For some currency pairs prices are not directly available and are rather derived by crossing the prices of underlying currency pairs.
- Crossing the prices to arrive at price of the currency pair could involve either multiplication or division of the underlying prices.
- In market parlance, the price of currency pair for which direct prices is not available is called as cross rate.

Impact of Market Economics on Currency Prices

Gross domestic product (GDP) growth rate, balance of payment situation, deficit situation, inflation, interest rate scenario, policies related to inflow and outflow of foreign capital are the factors affecting exchange rate.

Demand supply mismatch would also have bearing on the direction of currency’s movement.

To assess the impact of economic factors on the currency market, it is important to understand the key economic concepts, key data releases, their interpretation and impact on market.

The analytical tools of foreign-exchange market are the same as that of stock market: fundamental analysis and technical analysis.

Economic Indicators

- Gross Domestic Product
- Retail Sales
- Industrial Production
- Consumer Price Index
- Nonfarm Payrolls
- Central Bank Meetings and Key Decisions

References

1. NISM's Currency Derivatives, (2024). (n.p.): Taxmann Publications Private Limited.
2. KK & Mattoo VJ, **Foreign Exchange: Principles and Practice,** Sultan Chand & Sons, New Delhi.
3. Taxmann’s(2019) ***Foreign Exchange Management 36th Edition,*** Taxmann Publication
4. William D. Gerdes, 2018, **The Basics of Foreign Exchange Market: A Monetary Systems Approach,** 2nd Edition, Business Expert Press.
5. Williams L. Richards, 2015, **Currency: Fundamentals and Functions,** (First Edition) Design Pub.
6. Esha Sharma(2015) , ***Foreign Exchange Management*** Laxmi Publication.
7. Jeevanandam. C(2020) ***Foreign Exchange&Risk Management*** Sultan Chand & Sons