TOPIC: OVERVIEW OF FOREIGN EXCHANGE MARKET

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Foreign Exchange Market

The foreign exchange market or forex market is the market where currencies are traded. The forex market is the world's largest financial market where trillions are traded daily. It is the most liquid among all the markets in the financial world.

Foreign Exchange Market

There are a wide range of participants in the foreign exchange market, including:

- **Commercial banks:**

  Banks are the most active participants in the forex market, trading on behalf of their clients and for their own accounts.

- **Central banks:**

  Central banks participate in the market to manage their country's monetary policy and stabilize currency values.

- **Hedge funds and investment firms:**

  These institutions trade in the forex market to generate returns for their clients.

- **Corporations:**

  Multinational corporations use the forex market to manage their currency risk, particularly when conducting international trade.

- **Retail traders:**

  Individual traders can participate in the forex market through online brokers, seeking to profit from currency price movements.

- **Governments:**

  Governments participate in the forex market to manage their currency values and maintain their country's economic stability.

Understanding the Foreign Exchange Market

- The foreign exchange market is an over-the-counter (OTC) marketplace that determines the exchange rate for global currencies.
- It is, by far, the largest financial market in the world and is made up of a global network of financial centers that transact 24 hours a day, closing only on the weekends.
- Currencies are always traded in pairs, so the "value" of one of the currencies in that pair is relative to the value of the other.

Features of the Foreign Exchange Market

The foreign exchange market has several key features that set it apart from other financial markets.

1. It is a decentralized market that operates 24 hours a day, 5 days a week, across multiple time zones.
2. It is the largest and most liquid market in the world, with high trading volumes and low transaction costs.
3. The market is influenced by a variety of factors, including economic indicators, geopolitical events, and central bank policies.
4. The market provides opportunities for traders to speculate on the movement of currency values through a range of trading strategies.
5. The market is accessible to a wide range of participants, including individuals, financial institutions, and governments.

Spot and Forward Market

A spot market is where spot commodities or other assets like currencies are traded for immediate delivery for cash. Forward and futures markets instead involve the trading of contracts where the purchase is to be completed at a later date (read on to the following question for more on this).

Spot Market with an Example

The exchange offers the current price and amount available to traders with access to the market on the basis of all orders made by participants. The New York Stock Exchange (NYSE) is an example of an exchange where traders buy and sell stocks. This is a spot market.

Forward Market

A forward market is a market where financial instruments are traded for future delivery or settlement. In a forward market, the buyer and the seller agree on the price, quantity, and delivery date of the financial instrument. The transaction is executed on a future date, as agreed upon by both parties. The settlement of the transaction happens on the delivery date of the financial instrument.

The forward market is widely used for trading currencies, where traders and investors hedge against currency fluctuations. It is also used for trading commodities, such as agricultural products, where the delivery of the product is scheduled at a future date. The forward market is less liquid than the spot market, and the prices of financial instruments are determined based on the expectations of the market conditions.

Differences between Spot and Forward Markets

The key differences between the spot and forward markets are as follows:

1. **Settlement:** In a spot market, the settlement of the transaction happens within two working days, while in a forward market, the settlement of the transaction happens on a future date, as agreed upon by both parties.
2. **Time Horizon:** In a spot market, the transaction happens immediately, while in a forward market, the transaction happens at a future date.
3. **Price Determination:** In a spot market, the price of the financial instrument is determined based on the market demand and supply, while in a forward market, the price is determined based on the expectations of the market conditions.
4. **Risk:** In a spot market, the risk is lower, as the transaction is executed immediately, while in a forward market, the risk is higher, as the transaction happens at a future date, and the market conditions may change.

Exchange rate mechanism

Exchange rate mechanism (ERM) is a set of procedures used to manage a country's currency exchange rate relative to other currencies. It is part of an economy's monetary policy and is put to use by central banks.

1. Countries manage their country's currency strength through a device called an exchange rate mechanism (ERM).
2. The exchange rate mechanism allows central banks to influence domestic currency prices of currency in foreign exchange markets.
3. Exchange rates that are actively managed through an adjustable peg rate establish a reasonable trading range for a currency's exchange rate.

Types of Exchange Rate Mechanisms

1. Fixed Exchange Rate

A fixed exchange rate is a type of exchange rate regime where a currency is fixed against the value of another currency, basket of other currencies, or gold.

There are several benefits and drawbacks of a fixed exchange rate. One major benefit is that a typical fixed exchange rate does not change based on market conditions. This allows for improved international trade and investments. The fixed exchange rate system can be used to control the behavior of currency by limiting inflation.

2. Adjustable Peg Rate

An adjustable peg rate floats on the market and changes with respect to economic conditions. Generally, the central bank will set a degree of flexibility anchored against a specific level or peg. It is then the central bank's responsibility to ensure that the target exchange rate remains at the peg.

Exchange rate determination in the spot and forward markets

The spot rate is the current exchange rate between two currencies, while the forward rate is the rate agreed upon for a future transaction. The spot rate is used to determine the forward rate, which is based on the current value of the currency, the risk-free rate, and the time until the contract matures.

The spot rate represents the current exchange rate, while the forward rate is a predetermined rate for future transactions.

Understanding their differences and applications can help individuals and businesses make informed decisions regarding currency conversion, hedging strategies, and investment planning.

The factors Determining Spot Exchange Rates

1. Balance of Payments:

Balance of Payments represents the demand for and supply of foreign exchange which ultimately determine the value of the currency. Exports, both visible and invisible, represent the supply side for foreign exchange. Imports, visible and invisible, create demand for foreign exchange.

2. Inflation:

Inflation in the country would increase the domestic prices of the commodities. With increase in prices exports may dwindle because the price may not be competitive. With the decrease in exports the demand for the currency would also decline; this in turn would result in the decline of external value of the currency.

3. Interest rate:

The interest rate has a great influence on the short – term movement of capital. When the interest rate at a centre rises, it attracts short term funds from other centres. This would increase the demand for the currency at the centre and hence its value.

4. Money Supply:

An increase in money supply in the country will affect the exchange rate through causing inflation in the country. It can also affect the exchange rate directly. An increase in money supply in the country relative to its demand will lead to large scale spending on foreign goods and purchase of foreign investments. The downward pressure on the external value of the currency then increases the cost of imports and so adds to inflation.

5. National Income:

An increase in national income reflects increase in the income of the residents of the country. This increase in the income increases the demand for goods in the country. If there is underutilized production capacity in the country, this will lead to increase in production.

6. Resource Discoveries:

When the country is able to discover key resources, its currency gains in value. A good example can be the have played by oil in exchange rates. When the supply of oil from major suppliers, such as Middles East, became insecure, the demand fro the currencies of countries self sufficient in oil arose.

7. Capital Movements:

There are many factors that influence movement of capital from one country to another. Short term movement of capital may be influenced buy the offer of higher interest in a country. If interest rate in a country rises due to increase in bank rate or otherwise, there will be a flow of short term funds into the country and the exchange rate of the currency will rise. Reverse will happen in case of fall in interest rates.

8. Political factors:

Political stability induced confidence in the investors and encourages capital inflow into the country. This hasthe effect of strengthening the currency of the country. On the other hand, where the political situation in the country is unstable, it makes the investors withdraw their investments. The outflow of capital from the country would weaken the currency.