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A Study on Foreign Exchange Market in India

BANOTH DEEPA
MBA
Kingston PG College, Ghatkesar

ABSTRACT

Outside Exchange alludes to remote monetary standards controlled by a nation for making installments to different nations. It might be characterized as trade of cash or credit in one nation for cash or credit in another. It covers strategies for installment, tenets and controls of installment and the foundations encouraging such installments. The papers expresses the entire points of interest of outside conversion scale in India. Outside Exchange rate (ForEx rate) is a standout amongst the most critical means through which a nation's relative level of monetary wellbeing is resolved. A nation's remote swapping scale gives a window to its monetary steadiness, which is the reason it is continually watched and dissected. In the event that you are considering sending or accepting cash from abroad, you have to watch out for the money trade rates. The swapping scale is characterized as "the rate at which one nation's cash might be changed over into another." It might vacillate day by day with the changing business sector powers of free market activity of monetary standards starting with one nation then onto the next. Thus; when sending or getting cash universally, it is vital to comprehend what decides trade rates.

Keywords: FOREX, India, Exchange

INTRODUCTION

A foreign exchange market refers to buying foreign currencies with domestic currencies and selling foreign currencies for domestic currencies. Thus it is a market in which the claims to foreign moneys are bought and sold for domestic currency. Exporters sell foreign currencies for domestic currencies and importers buy foreign currencies with domestic currencies.

According to Ellsworth, “A Foreign Exchange Market comprises of all those institutions and individuals who buy and sell foreign exchange which may be defined as foreign money or any liquid claim on foreign money”. Foreign Exchange transactions result in inflow & outflow of foreign exchange.

Growth of Foreign Exchange Market in India

The Foreign Exchange Market in India is growing very rapidly, since the annual turnover of the market is more than $400 billion. This Foreign Exchange transaction in India does not include the Inter-Bank transactions. According to the record of Foreign Exchange in India, Reserve Bank of India released these transactions. The average monthly turnover in the merchant segment was $40.5 billion in 2003-04 and the Inter-Bank transaction was $134.2 for the same period. The

average total monthly turnover in the sector of Foreign Exchange in India was about $174.7 billion for the same period. The transactions are made on spot and also on forward basis, which include currency swaps and interest rate swaps.

The Indian Foreign Exchange Market is made up of the buyers, sellers, market mediators and the Monetary Authority of India. The main centre of Foreign Exchange in India is Mumbai, the commercial capital of the country. There are several other centres for Foreign Exchange Transactions in India including the major cities of Kolkata, New Delhi, Chennai, Bangalore, Pondicherry and Cochin. With the development of technologies, all the Foreign Exchange Markets of India work collectively and in much easier process.

Foreign Exchange Dealers Association is a voluntary association that also provides some help in regulating the market. The Authorised Dealers and the attributed brokers are qualified to participate in the Foreign Exchange Markets of India. When the Foreign Exchange Trade is going on between Authorized Dealers and Reserve Bank of India or between the Authorised Dealers and the Overseas Banks, the brokers usually do not have any role to play. Besides the Authorised Dealers and Brokers, there are some others who are provided with the limited rights to accept the Foreign Currency or Travellers' Cheque; they are the Authorised Moneychangers, Travel Agents, certain Hotels and Government Shops. The IDBI and Exim Bank are also permitted at specific times to hold Foreign Currency.

FUNCTIONS OF FOREIGN EXCHANGE MARKET

Foreign exchange is also referred to as forex market. Participants are importers, exporters, tourists and investors, traders and speculators, commercial banks, brokers and central banks.

Foreign bill of exchange, telegraphic transfer, bank draft, letter of credit etc. are the important foreign exchange instruments used in foreign exchange market to carry out its functions.

The Foreign Exchange Market performs the following functions.

1. Transfer Of Purchasing Power

Clearing Function The basic function of the foreign exchange market is to facilitate the conversion of one currency into another i.e. payment between exporters and importers. For eg. Indian rupee is converted into U.S. dollar and vice-versa. In performing the transfer function variety of credit instruments are used such as telegraphic transfers, bank drafts and foreign bills. Telegraphic transfer is the quickest method of transferring the purchasing power.

2. Credit Function

The foreign exchange market also provides credit to both national and international, to promote foreign trade. It is necessary as sometimes, the international payments get delayed for 60 days or 90 days. Obviously, when foreign bills of exchange are used in international payments, a credit for about 3 months, till their maturity, is required. For eg. Mr. A can get his bill discounted with a foreign exchange bank in New York and this bank will transfer the bill to its

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correspondent in India for collection of money from Mr. B after the stipulated time.

3.Hedging Function

A third function of foreign exchange market is to hedge foreign exchange risks. By hedging, we mean covering of a foreign exchange risk arising out of the changes in exchange rates. Under this function the foreign exchange market tries to protect the interest of the persons dealing in the market from any unforseen changes in exchange rate. The exchange rates under free market can go up and down, this can either bring gains or losses to concerned parties. Hedging guards the interest of both exporters as well as importers, against any changes in exchange rate.

Hedging can be done either by means of a spot exchange market or a forward exchange market involving a forward contract.

PARTICIPANTS / DEALERS IN FOREIGN EXCHANGE MARKET

Foreign exchange market needs dealers to facilitate foreign exchange transactions. Bulk of foreign exchange transaction is dealt by Commercial banks & financial institutions. RBI has also allowed private authorised dealers to deal with foreign exchange transactions i.e buying & selling foreign currency. The main participants in foreign exchange markets are

1. Retail Clients Retail Clients deal through commercial banks and authorised agents. They comprise people, international investors, multinational corporations and others who need foreign exchange.

2. Commercial Banks Commercial banks carry out buy and sell orders from their retail clients and of their own account. They deal with other commercial banks and also through foreign exchange brokers.

3. Foreign Exchange Brokers Each foreign exchange market centre has some authorised brokers. Brokers act as intermediaries between buyers and sellers, mainly banks. Commercial banks prefer brokers.

4. Central Banks Under floating exchange rate central bank does not interfere in exchange market. Since 1973, most of the central banks intervened to buy and sell their currencies to influence the rate at which currencies are traded. From the above sources demand and supply generate which in turn helps to determine the foreign exchange rate.

TYPES OF FOREIGN EXCHANGE MARKET

Foreign Exchange Market is of two types' retail and wholesale market.

1. Retail Market

The retail market is a secondary price maker. Here travellers, tourists and people who are in need of foreign exchange for permitted small transactions, exchange one currency for another.

2. Wholesale Market

The wholesale market is also called interbank market. The size of transactions in this market is very large. Dealers are highly professionals and are primary price makers. The main participants are Commercial banks, Business corporations and Central banks. Multinational banks are mainly responsible for determining exchange rate.

3. Other Participants

a) Brokers have more information and better knowledge of market. They provide information to banks about the prices at

which there are buyers and sellers of a pair of currencies. They act as middlemen between the price makers.

b) Price Takers Price takers are those who buy foreign exchange which they require and sell what they earn at the price determined by primary price makers.

c) Indian Foreign Exchange Market It is made up of three tiers

SPOT AND FORWARD EXCHANGE RATES

Transactions in exchange market are carried out at what are termed as exchange rates. In foreign exchange market two types of exchange rate operations take place. They are spot exchange rate and forward exchange rate.

1) Spot Exchange Rate :-

When foreign exchange is bought and sold for immediate delivery, it is called spot exchange. It refers to a day or two in which two currencies are involved. The basic principle of spot exchange rate is that it can be analysed like any other price with the help of demand and supply forces.

The exchange rate of dollar is determined by intersection of demand for and supply of dollars in foreign exchange. The Remand for dollar is derived from country's demand for imports which are paid in dollars and supply is derived from country's exports which are sold in dollars. The exchange rate determined by market forces would change as these forces change in market. The primary price makers buy (Bid) or sell (ask) the currencies in the market and the rates continuously change in a free market depending on demand and supply. The primary dealer (bank) quotes two-way rates i.e., buy and sell rate. (Bid) Buy Rate 1 US $ = ` 45.50 (Ask) Sell Rate 1 US $ = ` 45.75

The bank is ready to buy 1 US $ at Rs. 45.50 and sell at Rs. 45,75. The difference of Rs.0.25 is the profit margin of dealer.

2) Forward Exchange Rate

Here foreign exchange is bought or sold for future delivery i.e., for the period of 30, 60 or 90 days: There are transactions for 180 and 360 days also. Thus, forward market deals in contract for future delivery. The price for such transactions is fixed at the time of contract, it is called a forward rate. Forward exchange rate differs from spot exchange rate as the former may either be at a premium or discount. If the forward rate is above the present spot rate, the foreign exchange rate is said to be at a premium. If the forward rate is below the present spot rate, the foreign exchange rate is said to be at a discount. Thus foreign exchange rate may be at forward premium or at forward discount. For E.g. an Indian importer may enter into an agreement to purchase US $ 10,000 sixty days from today at 1 US $ = Rs. 48. No amount is paid at the time of agreement, except for usual security margin money of about 10% of the total amount. 60 days form today, the importer will get 10,000 US $ in exchange for Rs. 4,80,000 irrespective of the Spot exchange rate prevailing on that date.

Factors Influencing Forward Exchange Rate

1) **Interest rates**-Changes in interest rate affect currency value and dollar exchange rate. Forex rates, interest rates, and inflation are all correlated. Increases in interest rates cause a country's currency to appreciate because higher interest rates

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provide higher rates to lenders, thereby attracting more foreign capital, which causes a rise in exchange rates

2) **Inflation rate-** Changes in market inflation cause changes in currency exchange rates. A country with a lower inflation rate than another does will see an appreciation in the value of its currency. The prices of goods and services increase at a slower rate where the inflation is low. A country with a consistently lower inflation rate exhibits a rising currency value while a country with higher inflation typically sees depreciation in its currency and is usually accompanied by higher interest rates

3. Country's Current Account / Balance of Payments

A country's current account reflects balance of trade and earnings on foreign investment. It consists of total number of transactions including its exports, imports, debt, etc. A deficit in current account due to spending more of its currency on importing products than it is earning through sale of exports causes depreciation. Balance of payments fluctuates exchange rate of its domestic currency.

4. Government Debt

Government debt is public debt or national debt owned by the central government. A country with government debt is less likely to acquire foreign capital, leading to inflation. Foreign investors will sell their bonds in the open market if the market predicts government debt within a certain country. As a result, a decrease in the value of its exchange rate will follow.

5. Terms of Trade

Related to current accounts and balance of payments, the terms of trade is the ratio of export prices to import prices. A country's terms of trade improves if its exports prices rise at a greater rate than its imports prices. This results in higher revenue, which causes a higher demand for the country's currency and an increase in its currency's value. This results in an appreciation of exchange rate.

6. Political Stability & Performance

A country's political state and economic performance can affect its currency strength. A country with less risk for political turmoil is more attractive to foreign investors, as a result, drawing investment away from other countries with more political and economic stability. Increase in foreign capital, in turn, leads to an appreciation in the value of its domestic currency. A country with sound financial and trade policy does not give any room for uncertainty in value of its currency. But, a country prone to political confusions may see depreciation in exchange rates.

7. Recession

When a country experiences a recession, its interest rates are likely to fall, decreasing its chances to acquire foreign capital. As a result, its currency weakens in comparison to that of other countries, therefore lowering the exchange rate.

8. Speculation

If a country's currency value is expected to rise, investors will demand more of that

currency in order to make a profit in the near future. As a result, the value of the currency will rise due to the increase in demand. With this increase in currency value comes a rise in the exchange rate as well.

b) Need for Forward Exchange Rate Contracts To overcome the possible risk of loss due to fluctuations in exchange rate, exporters, importers and investors in other countries may enter in forward exchange rate contracts. In floating or flexible exchange rate system the possibility of wide fluctuation in exchange is more. Thus, both exporters and importers safeguard their position through a forward arrangement. By entering into such an arrangement both parties minimize their loss.

CONCLUSION

Albeit outside trade might befuddle, in the present worldwide commercial centre, there is a basic requirement for practically everybody to comprehend remote trade more than ever. As the world therapists, there is a regularly improving probability that we will be required to address the dangers related with the way that there are distinctive monetary standards utilized all around the globe and that these monetary standards will immediate affect our reality. We should have the capacity to assess the impacts of, and effectively react to, changes in return rates as for our utilization choices, speculation portfolios, strategies for success, government approaches, and other life decisions (both money related and something else). Also, there is a regularly expanding likelihood that we should execute in these outside trade markets—in our own or expert life.

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