How transaction (supply and demand) of currency takes place in the foreign exchan...

Business, Marketing

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Introduction

Foreign exchange market is an international, decentralized market for trading of currencies of different countries (DeRosa, 2011). This market is made up of the financial institutions, especially banks that are ready to exchange one currency for another. DeRosa (2011), explain that exchanging money means trading one currency for another and the value at which exchange takes place is called exchange rate, which is the price of that currency. Most of the transactions take place in United States, United Kingdom, and Japan with most of the rest market located in Germany, Australia, Singapore, and France. Foreign market is fully liberalized with exchange rates being controlled by the force of demand and supply (Honoré, 2010).

Currency are purchased and sold just as ordinary goods and services. Transactions also occur between different participants just as in a regular market. The world's everyday transactions exchanges are mainly between the dollars and euro (30%), the dollar and yen (20%) and the dollar and pounds Sterling (Veraart, 2011). The way currency are created depends on whether they are determined in the free markets known as freely floating or

determined by agreements between governments identified as pegged or fixed.

Foreign exchange market is also driven by the effects of demand and supply. Demand refers to the measure of how much consumers want at any particular time (Honoré, 2010). When the demand for a currency increases it becomes more valuable and when demand decreases it become less valued. Again, supply is a measure of how much an individual good or service is available at a given time. The value of a commodity that in this case is the currency, directly depend on its supply. When the supply is low, the currency becomes more valuable as compared to when the supply is high.

The demand for currency is obtained from the demand for countries exports and from speculators planning to generate a profit on deviations in currency values. Honore (2010) argues that the demand for currency also relies on what is occurring in that country. When interest rate paid by countries central bank is higher, that currency will be more valuable. Consequently, investors will want to exchange their currency for higher-paying ones so as to save in the banks of that country to receive more interest rate.

On the other hand, supply of currency relies on the domestic demand for imports from outside (Veraart, 2011). For instance, when America imports a machine from Japan they must pay in Japan currency, (Yen) and to buy Yen they must sell their currency (Dollars) which in this case is the supply. The more America imports, the greater the supply of dollars onto the foreign exchange market.

An exchange rate equates demand and supply for a given currency against another currency. For example, If British and France produce goods that the

other wants, they will need to trade. However, the producer will require payments in Euro, and the British producers will require payments in pounds Sterling. Both parties make payments in their in order to pay the producers in their countries (Veraart, 2011).

Another transaction that takes place in foreign exchange market is the spot transactions. Options on foreign exchange. Hoboken, N. J.: Wiley.. Options on foreign exchange. Hoboken, N. J.: Wiley.. In this transaction, one person accepts to exchange one currency for another depending on factors favoring demand and supply. This transaction happens in two businesses particularly for currencies of nations that are in a different hemisphere, For example, United States and France whose currency stabilized in a single business day. Since this trade does not involve all dealers, one party is compelled to call another party and demands for a bid into business and asks for a price for a specific currency. However, both sides are interested in a transaction, either to purchase or to sell. Each party will be interested in both prices in order not to alert the other party to increase the price depending on the prevailing condition of demand and supply. Because when demand for that particular currency is high, the seller will increase the exchange rate while when the supply is high, the buyer will bid lower exchange rate.

Again, another transaction that exists in foreign exchange market is forward transaction. This transaction, parties accept to form a forward contract where negotiated prices are determined using forward exchange rate which relies on the current nature of demand and supply since their effects significantly affect the exchange rate. The exchange rate is also calculated based on the interest rate of the country and on the settlement day when

actual payments will be made.

Furthermore, there is a transaction known as currency Swap where one party is selling a commodity while the other person is paying for it. This type of operation is a modified form of forward transaction where the people exchanged currency when they agreed with the existing behaviors of demand and supply. Once the contract is over the parties terminate it entirely. This transaction is the most familiar type of forward transaction. Credit risks are highly limited to the difference in the value of the two currency involved on the settlements.

Conclusion

Finally, foreign exchange market is highly determined by the behaviors of demand and supply which determine the rates of exchange to be charged on a particular currency hence determining profitability or loss in the business involving foreign exchange market.

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