Forex management assignment

Business

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UNIT – I Foreign Exchange Markets A Foreign exchange market is a market in which currencies are bought and sold. It is to be distinguished from a financial market where currencies are borrowed and lent. General Features Foreign exchange market is described as an OTC (Over the counter) market as there is no physical place where the participants meet to execute their deals. It is more an informal arrangement among the banks and brokers operating in a financing centre purchasing and selling currencies, connected to each other by tele communications like telex, telephone and a satellite communication network, SWIFT.

The term foreign exchange market is used to refer to the wholesale a segment of the market, where the dealings take place among the banks. The retail segment refers to the dealings take place between banks and their customers. The retail segment refers to the dealings take place between banks and their customers. The retail segment is situated at a large number of places. They can be considered not as foreign exchange markets, but as the counters of such markets. The leading foreign exchange market in India is Mumbai, Calcutta, Chennai and Delhi is other centers accounting for bulk of the exchange dealings in India.

The policy of Reserve Bank has been to decentralize exchages operations and develop broader based exchange markets. As a result of the efforts of Reserve Bank Cochin, Bangalore, Ahmadabad and Goa have emerged as new centre of foreign exchange market. Size of the Market Foreign exchange market is the largest financial market with a daily turnover of over USD 2 trillion. Foreign exchange markets were primarily developed to facilitate settlement of debts arising out of international trade.

But these markets have developed on their own so much so that a turnover of about 3 days in the foreign exchange market is equivalent to the magnitude of world trade in goods and services. The largest foreign exchange market is London followed by New York, Tokyo, Zurich and Frankfurt. The business in foreign exchange markets in India has shown a steady increase as a consequence of increase in the volume of foreign trade of the country, improvement in the communications systems and greater access to the international exchange markets.

Still the volume of transactions in these markets amounting to about USD 2 billion per day does not compete favorably with any well developed foreign exchange market of international repute. The reasons are not far to seek. Rupee is not an internationally traded currency and is not in great demand. Much of the external trade of the country is designated in leading currencies of the world, Viz. , US dollar, pound sterling, Euro, Japanese yen and Swiss franc.

Incidentally, these are the currencies that are traded actively in the foreign exchange market in India. 24 Hours Market The markets are situated throughout the different time zones of the globe in such a way that when one market is closing the other is beginning its operations. Thus at any point of time one market or the other is open. Therefore, it is stated that foreign exchange market is functioning throughout 24 hours of the day. However, a specific market will function only during the business hours.

Some of the banks having international network and having centralized control of funds management may keep their foreign exchange department in the key centre open throughout to keep up with developments at other centers during their normal working hours In India, the market is open for the time the banks are open for their regular banking business. No transactions take place on Saturdays. Efficiency Developments in communication have largely contributed to the efficiency of the market. The participants keep abreast of current happenings by access to such services like Dow Jones Telerate and Teuter.

Any significant development in any market is almost instantaneously received by the other market situated at a far off place and thus has global impact. This makes the foreign exchange market very efficient as if the functioning under one roof. Currencies Traded In most markets, US dollar is the vehicle currency, Viz. , the currency used to denominate international transactions. This is despite the fact that with currencies like Euro and Yen gaining larger share, the share of US dollar in the total turn over is shrinking.

Physical Markets In few centers like Paris and Brussels, foreign exchange business takes place at a fixed place, such as the local stock exchange buildings. At these physical markets, the banks meet and in the presence of the representative of the central bank and on the basis of bargains, fix rates for a number of major currencies. This practice is called fixing. The rates thus fixed are used to execute customer orders previously placed with the banks. An advantage claimed for this procedure is that exchange rate for commercial transactions will be market determined, not influenced by any one bank.

However, it is observed that the large banks attending such meetings with large commercial orders backing up, tend to influence the rates. Participants The participants in the foreign exchange market comprise; (i) (ii) (iii) (iv) Corporates Commercial banks Exchange brokers Central banks Corporates: The business houses, international investors, and multinational corporations may operate in the market to meet their genuine trade or investment requirements. They may also buy or sell currencies with a view to speculate or trade in currencies to the extent permitted by the exchange control regulations.

They operate by placing orders with the commercial banks. The deals between banks and their clients form the retail segment of foreign exchange market. In India the foreign Exchange Management (Possession and Retention of Foreign Currency) Regulations, 2000 permits retention, by resident, of foreign currency up to USD 2, 000. Foreign Currency Management (Realisation, Repatriation and Surrender of Foreign Exchange) Regulations, 2000 requires a resident in India who receives foreign exchange to surrender it to an authorized dealer: a) Within seven days of receipt in case of receipt by way of remuneration, settlement of lawful obligations, income on assets held abroad, inheritance, settlement or gift: and (b) Within ninety days in all other cases. Any person who acquires foreign exchange but could not use it for the purpose or for any other permitted purpose is required to surrender the unutilized foreign exchange to authorized dealers within sixty days from the date of acquisition.

In case the foreign exchange was acquired for travel abroad, the unspent foreign exchange should be surrendered within ninety days from the date of return to India when the foreign exchange is in the form of foreign currency notes and coins and within 180 days in case of travellers cheques. Similarly, if a resident required foreign exchange for an approved purpose, he should obtain from and authorized dealer. Commercial Banks are the major players in the market. They buy and sell currencies for their clients. They may also operate on their own.

When a bank enters a market to correct excess or sale or purchase position in a foreign currency arising from its various deals with its customers, it is said to do a cover operation. Such transactions constitute hardly 5% of the total transactions done by a large bank. A major portion of the volume is accounted buy trading in currencies indulged by the bank to gain from exchange movements. For transactions involving large volumes, banks may deal directly among themselves. For smaller transactions, the intermediation of foreign exchange brokers may be sought.

Exchange brokers facilitate deal between banks. In the absence of exchange brokers, banks have to contact each other for quotes. If there are 150 banks at a centre, for obtaining the best quote for a single currency, a dealer may have to contact 149 banks. Exchange brokers ensure that the most favorable quotation is obtained and at low cost in terms of time and money. The bank may leave with the broker the limit up to which and the rate at which it wishes to buy or sell the foreign currency concerned. From the intends from other banks, the broker will be able to match the requirements of both.

The names of the counter parities are revealed to the banks only when the deal is acceptable to them. Till then anonymity is maintained. Exchange brokers tend to specialize in certain exotic currencies, but they also handle all major currencies. In India, banks may deal directly or through recognized exchange brokers. Accredited exchange brokers are permitted to contract exchange business on behalf of authorized dealers in foreign exchange only upon the understanding that they will conform to the rates, rules and conditions laid down by the FEDAI.

All contracts must bear the clause “ subject to the Rules and Regulations of the Foreign Exchanges Dealers ‘ Association of India’. Central Bank may intervene in the market to influence the exchange rate and change it from that would result only from private supplies and demands. The central bank may transact in the market on its own for the above purpose. Or, it may do so on behalf of the government when it buys or sell bonds and settles other transactions which may involve foreign exchange payments and receipts.

In India, authorized dealers have recourse to Reserve Bank to sell/buy US dollars to the extent the latter is prepared to transact in the currency at the given point of time. Reserve Bank will not ordinarily buy/sell any other currency from/to authorized dealers. The contract can be entered into on any working day of the dealing room of Reserve Bank. No transaction is entered into on Saturdays. The value date for spot as well as forward delivery should be in conformity with the national and international practice in this regard.

Reserve Bank of India does not enter into the market in the ordinary course, where the exchages rates are moving in a detrimental way due to speculative forces, the Reserve Bank may intervene in the market either directly or through the State Bank of India. Settlement of Transactions

Foreign exchange markets make extensive use of the latest developments in telecommunications for transmitting as well settling foreign exchange transaction, Banks use the exclusive network SWIFT to communicate messages and settle the transactions at electronic clearing houses such as CHIPS at New York.

SWIFT: SWIFT is a acronym for Society for Worldwide Interbank Financial Telecommunications, a co operative society owned by about 250 banks in Europe and North America and registered as a co operative society in Brussels, Belgium. It is a communications network for international financial market transactions linking effectively more than 25, 000 financial institutions throughout the world who have been allotted bank identified codes. The messages are transmitted from country to country via central interconnected operating centers located in Brussels, Amsterdam and Culpeper, Virginia.

The member countries are connected to the centre through regional processors in each country. The local banks in each country reach the regional processors through the national net works. The SWIFY System enables the member banks to transact among themselves quickly (i) international payments (ii) Statements (iii) other messages connected with international banking. Transmission of messages takes place within seconds, and therefore this method is economical as well as time saving. Selected banks in India have become members of SWIFT. The regional processing centre is situated at Mumbai.

The SWIFT provides following advantages for the local banking community: 1. Provides a reliable (time tested) method of sending and receiving messages from a vast number of banks in a large number of locations around the world. 2. Reliability and accuracy is further enhanced by the built in authentication facilities, which has only to be exchanged with each counterparty before they can be activated or further communications. 3. Message relay is instantaneous enabling the counterparty to respond immediately, if not prevented by time differences. 4. Access is available t a vast number of banks global for launching new cross border initiatives. . Since communication in SWIFT is to be done using structure formats for various types of banking transactions, the matter to be conveyed will be very clear and there will not be any ambiguity of any sort for the received to revert for clarifications. This is mainly because the formats are used all ove3r the world on a standardized basis for conducting all types of banking transactions. This makes the responses and execution very efficient at the receiving banks end thereby contributing immensely to quality service being provided to the customers of both banks (sending and receiving). 6.

Usage of SWIFT structure formats for message transmission to counterparties will entail the generation of local banks internal records using at least minimum level of automation. This will accelerate the local banks internal automation activities, since the maximum utilization of SWIFT a significant internal automation level is required. CHIPS: CHIPS stands for Clearing House Interbank Payment System. It is an electronic payment system owned by 12 private commercial banks constituting the New York

Clearing House Association. A CHIP began its operations in 1971 and has grown to be the world's largest payment system.

Foreign exchange and Euro dollar transactions are settled through CHIPS. It provides the mechanism for settlement every day of payment and receipts of numerous dollar transactions among member banks at New York, without the need for physical exchange of cheques/funds for each such transaction. The functioning of CHIPS arrangement is explained below with a hypothetical transaction: Bank of India, maintaining a dollar account with Amex Bank, New York, sells USD 1 million to Canara Bank, maintaining dollar account with Citibank. 1.

Bank of India intimate Amex Bank debuts the account of Bank through SWIFT to debit its account and transfer USD 1 million to Citibank for credit of current account of Canara Bank. 2. Amex Bank debits the account of Bank of India with USD 1 million and sends the equivalent of electronic cheques to CHIPS for crediting the account of Citibank. The transfer is effected the same day. 3. Numerous such transactions are reported to CHIPS by member banks and transfer effected at CHIPS. By about 4. 30 p. m, eastern time, the net position of each member is arrived at and funds made available at Fedwire for use by the bank concerned by 6. 0 p. m. eastern time. 4. Citibank which receives the credit intimates Canara Bank through SWIFT. It may be noted that settlement of transactions in the New York foreign exchange market takes place in two stages, First clearance at CHIPS and arriving at the net position for each bank. Second, transfer of fedfunds for the net position. The real balances are held by banks only with Federal Reserve Banks (Fedfunds) and the transaction is complete only when Fedfunds are transferred. CHIPS help in expediting the reconciliation and reducing the number of entries that pass through Fedwire.

CHAPS is an arrangement similar to CHIPS that exists in London. CHAPS stands for Clearing House Automated Payment System. Fedwire The transactions at New York foreign exchange market ultimately get settled through Fedwire. It is a communication network that links the computers of about 7000 banks to the computers of federal Reserve Banks. The fedwire funds transfer system, operate by the Federal Reserve Bank, are used primarily for domestic payments, bank to bank and third party transfers such as interbank overnight funds sales and purchases and settlement transactions.

Corporate to corporate payments can also be made, but they should be effected through banks. Fed guarantees settlement on all payments sent to receivers even if the sender fails. TRANSACTIONS IN INTERBANK MARKETS The exchange rates quoted by banks to their customer are based on the rates prevalent in the interbank market. The big banks in the market are known as market makers, as they are willing to buy or sell foreign currencies at the rates quoted by them up to any extent. Depending buy or sell foreign currencies at the rates quoted by them up to any extent.

Depending upon its resources, a bank may be a market maker in one or few major currencies. When a banker approaches the market maker, it would not reveal its intention to buy or sell the currency. This is done in order to get a fair price from the market maker. Two Way Quotations Typically, the quotation in the interbank market is a two ??? way quotation. It means the rate quoted by the market maker will indicate two prices. One at which it is willing to buy the foreign currency, and the other at which it is willing to sell the foreign currency. For example, a Mumbai bank may quote its rate for US dollar as under

USD 1 = Rs 48. 1525/1650 More often, the rate would be quoted as 1525/1650 since the players in the market are expected to know the ‘ big number’ i. e. , Rs 48. In the given quotation, one rate is Rs. 48. 1525 per dollar and the other rate is Rs. 48. 1650. per dollar. Direct Quotation. It will be obvious that the quoting bank will be willing to buy dollars at Rs 48. 1525 and sell dollars at Rs 48. 1650. If one dollar bought and sold, the bank makes a gross profit of Rs. 0. 0125. In a foreign exchange quotation, the foreign currency is the commodity that is being bought and sold.

The exchange quotation which gives the price for the foreign currency in terms of the domestic currency is known as direct quotation. In a direct quotation, the quoting bank will apply the rule: “ Buy low; Sell high”. Indirect quotation There is another way of quoting in the foreign exchange market. The Mumbai bank quotes the rate for dollar as: Rs. 100 = USD 2. 0762/0767 This type of quotation which gives the quantity of foreign currency per unit of domestic currency is known as indirect quotation. In this case, the quoting bank will receive USD 2. 0767 per Rs. 100 while buying dollars and give away USD 2. 762 per Rs. 100 while selling dollars. In other world, he will apply the rule: “ Buy high: Sell low”. The buying rate is also known as the ‘ bid rate and selling rate as the ‘ offer’ rate. The difference between these rates is the gross profit for the bank and is known as the ‘ Spread’. Spot and Forward transactions The transactions in the interbank market may place for settlement (a) on the same day; or (b) two days later; or (c) some day late; say after a month Where the agreement to buy and sell is agreed upon and executed on the same date, the transaction is known as cash or ready transaction.

It is also known as value today. The transaction where the exchange of currencies takes place two days after the date of the contact is known as the spot transaction. For instance, if the contract is made on Monday, the delivery should take place on Wednesday. If Wednesday is a holiday, the delivery will take place on the next day, i. e. , Thursday. Rupee payment is also made on the same day the foreign currency is received. The transaction in which the exchange of currencies takes places at a specified future date, subsequent to the spot date, is known as a forward transaction.

The forward transaction can be for delivery one month or two months or three months etc. A forward contract for delivery one month means the exchange of currencies will take place after one month from the date of contract. A forward contract for delivery two months means the exchange of currencies will take place after two months and so on. Forward Margin/Swap points Forward rate may be the same as the spot rate for the currency. Then it is said to be ‘ at par’ with the spot rate. But this rarely happens. More often the forward rate for a currency may be costlier or chapter tan its spot rate.

The rate for a currency may be costlier or cheaper than nits spot rate. The difference between the forward rate and the spot rate is known as the ‘ forward margin’ or swap points. The forward margin may be either at ‘ premium’ or at ‘ discount’. If the forward margin is at premium, the foreign correct will be costlier under forward rate than under the spot rate. If the forward margin is at discount, the foreign currency will be cheaper for forward delivery then for spot delivery. Under direct quotation, premium is added to spot rate to arrive at the forward rate.

This is done for both purchase and sale transactions. Discount is deducted from the spot rate to arrive at the forward rate. Interpretation of Interbank quotations The market quotation for a currency consists of the spot rate and the forward margin. The outright forward rate has to be calculated by loading the forward margin into the spot rate. For instance, US dollar is quoted as under in the interbank market on 25th January as under: Spot Spot/February Spot/March USD 1 = Rs. 48. 4000/4200 2000/2100 3500/3600 The following points should be noted in interpreting the above quotation; 1.

The first statement is the spot rate for dollars. The quoting bank buying rate is Rs. 48. 4000 and selling rate is Rs. 48. 4200. 2. The second and third statements are forward margins for forward delivery during the months of February. Spot/March respectively. Spot/February rate is valid for delivery end February. Spot/March rate is valid for delivery end March. 3. The margin is expressed in points, i. e. , 0. 0001 of the currency. Therefore the forward margin for February is 20 paise and 21 paise. 4. The first rate in the spot quotation is for buying and second for selling the foreign currency.

Correspondingly, in the forward margin, the first rate relates to buying and the second to selling. Taking Spot/February as an example, the margin of 20 paise is for purchase and 21 paise is for sale of foreign currency. 5. Where the forward margin for a month is given in ascending order as in the quotation above, it indicates that the forward currency is at premium. The outright forward rates arrived at by adding the forward margin to the spot rates. The outright forward rates for dollar can be derived from the above quotations follows Buying rate February Spot rate Add; Premium 48. 000 48. 4000 0. 2000 ————-March 48. 4000 0. 3500 ———–48. 7500 February 48. 4200 0. 2100 ————48. 6300 48. 7800 Selling rate March 48. 4200 0. 3600 From the above calculation we arrive at the following outright rates; Buying Spot delivery Forward delivery February Forward delivery March USD 1 = Rs. 48. 4000 48. 6000 48. 7500 Selling 48. 4200 48. 6300 48. 7800 If the forward currency is at discount, it would be indicated by quoting the forward margin in the descending order.

Suppose that on 20th April, the quotation for pound sterling in the interbank market is as follows: Spot Spot/May Spot/June GBR 1 = Rs. 73. 4000/4300 3800/3600 5700/5400 Since the forward margin is in descending order (3800/3600), forward sterling is at discount. The outright forward rates are calculated by deducting the related discount from the spot rate. Thus is shown below: Buying rate May Spot rate Less; discount 73. 4000 0. 3800 ———–73. 0200 June 73. 4000 0. 5700 ———–72. 8300 May 73. 4300 0. 3600 Selling rate June 73. 4300 0. 5400 72. 8900 ————73. 700 From the above calculations the outright rates for pound sterling cab be restated as follows; Buying Spot Forward delivery May Forward delivery June GBR 1 = Rs. 73. 4000 73. 0200 72. 8300 Selling 73. 4300 73. 0700 72. 8900 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.

Put differently, export from the country creates demand for the currency of the country in the foreign exchange market. The exporters would offer to the market the foreign currencies they have acquired and demand in exchange the local currency. Conversely, imports into the country will increase the supply of the currency of the country in the foreign exchange market. When the balance of payments of a country is continuously at deficit, it implies that the demand for the currency of the country is lesser than its supply. Therefore, its value in the market declines.

If the balance of payments is surplus continuously it shows that the demand for the currency in the exchange market is higher than its supply therefore the currency gains in value. (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. It may be noted that unit is the relative rate of inflation in the two countries that cause changes in exchange rates.

If, for instance, both India and the USA experience 10% inflation, the exchange rate between rupee and dollar will remain the same. If inflation in India is 15% and in the USA it is 10%, the increase in prices would be higher in India than it is in the USA. Therefore, the rupee will depreciate in value relative to US dollar. Empirical studies have shown that inflation has a definite influence on the exchange rates in the long run. The trend of exchange rates between two currencies has tended to hover around the basic rate discounted for the inflation factor.

The actual rates have varied from the trend only by a small margin which is acceptable. However, this is true only where no drastic change in the economy of the country is. New resources found may upset the trend. Also, in the short run, the rates fluctuate widely from the trend set by the inflation rate. These fluctuations are accounted for by causes other than inflation. (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 centers. This would increase the demand for the currency at the entre and hence its value. Rising of interest rate may be adopted by a country due to tight money conditions or as a deliberate attempt to attract foreign investment. Whatever be the intention, the effect of an increase in interest rate is to strengthen the currency of the country through larger inflow of investment and reduction in the outflow of investments by the residents of the country. (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 upply in the country relative to its demand will lead to large scale spending on foreign goods and purchase of foreign investments. Thus the supply of the currency in the foreign exchange markets is increased and its value declines. The downward pressure on the external value of the currency then increases the cost of imports and so adds to inflation. The effect of money supply on exchange rate directly is more immediate than its effect through inflation. While in the long run inflation seems to correlate exchange rate variations in a better way, in the short run exchange rates move more in sympathy with changes in money supply.

One explanation of how changes in money supply vary the exchange rate is this; the total money supply in the country represents the value of total commodities and services in the country. Based on this the outside world determines the external value of the currency. If the money supply is doubles, the currency will be valued at half the previous value so as to keep the external value of the total money stock of the country constant. Another explanation offered is that the excess money supply flows out of the country and directly exerts a pressure on the exchange rate.

The excess money created, the extent they are in excess of the domestic demand for money, will flow out of the country. This will increase the supply of the currency and pull down its exchange rate. (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. There is a chance for growth in exports too. But more often it takes time for the production to adjust to the increased income.

Where the production does not increase in sympathy with income rise, it leads to increased imports and increased supply of the currency of the country in the foreign exchange market. The result is similar to that of inflation, viz. , and decline in the value of the currency. Thus an increase in national income will lead to an increase in investment or in consumption, and accordingly, its effect on the exchange rate will change. Here again it is the relative increase in national incomes of the countries concerned that is to be considered and not the absolute increase. 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. Previous oil crisis favoured USA, Canada, UK and Norway and adversely affected the currencies of oil importing countries like Japan and Germany. Similarly, discovery oil by some countries helped their currencies to gain in value. The discovery of North Sea oil by Britain helped pound sterling to rise to over USD 2. 0 from USD 1. 60 in a couple of years. Canadian dollar also benefited from discoveries of oil and gas off the Canadian East Coast and the Arctic. (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.

Bright investment climate and political stability may encourage portfolio investments in the country. This leads to higher demand for the currency and upward trend in its rate. Poor economic outlook may mean repatriation of the investments leading to decreased demand and lower exchange value for the currency of the country. Movement of capital is also caused by external borrowing and assistance. Large scale external borrowing will increase the supply of foreign exchange in the market. This will have a favorable effect on the exchange rate of the currency of the country.

When repatriation of principal and interest starts the rate may be adversely affected. (8) Political factors Political stability induced confidence in the investors and encourages capital inflow into the country. This has the 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. Any news about change in the government or political leadership or about the policies of the government would also have the ffect of temporarily throwing out of gear the smooth functioning of exchange rate mechanism. Functions of foreign Exchange Market The foreign exchange market is a market in which foreign exchange transactions take place. Transfer of Purchasing Power The Primary function of a foreign exchange market is the transfer of purchasing power from one country to another and from one currency to another. The international clearing function performed by foreign exchange markets plays a very important role in facilitating international trade and capital movement.

Provision of credit The credit function performed by foreign exchange markets also plays a very important role in the growth of foreign trade, for international trade depends to a great extent on credit facilities. Exporters may get pre shipment and post shipment credit. Credit facilities are available also for importers. The Euro dollar market has emerged as a major international credit market. Provision of Heding Facilities The other important of the foreign exchange market is to provide hedging facilities.

Heding refers to covering of foreign trade risks, and it provides a mechanism to exporters and importers to guard themselves against losses arising from fluctuations in exchange rates. Methods of Affecting International Payments There are important methods to effect international payments. Transfers Money may be transferred from a bank in one country to a bank in another part of the world be electronic or other means Cheques and Bank Drafts International payments may be made be means of cheques and bank drafts. The latter is widely used. A bank draft is a cheque drawn on a bank instead of a customer’s personal account.

It is an acceptable means of payment when the person tendering is not known, since its value is dependent on the standing of a bank which is widely known, and not on the credit worthiness of a firm or individual known only to a limited number of people. Foreign Bill of Exchange A bill of exchange is an unconditional order in writing, addressed by one person to another, requiring the person to whom it is addressed to pay a certain sum or demand or on a specified future date. There are two important differences between inland and foreign bills.

The date on which an inland bill is due for payment is calculated from the date on which it was drawn, but the period of a foreign bill runs fro m the date on which the bill was accepted. The reason for this is that the interval between a foreign bill being drawn and its acceptance may be considerable, since it may depend on the time taken for the bill to pass fro m the drawers country to that of the acceptor. The second important difference between the two types of bill is that the foreign bill is generally drawn in sets of three, although only one of them bears a stamp and of course one of them is paid.

Now days it is mostly the documentary bill that is employed in international trade. This is nothing more than a bill of exchange with the various shipping documents the bill of lading, the insurance certificate and the consular invoice attached to it. By using this the exporter can make the release of the documents conditional upon either (a) payment of the bill if it has been drawn at sight or (b) Its acceptance by the importer if it has been drawn for a period. Transactions in the foreign Exchange Market

A very brief account of certain important types of transactions conducted in the foreign exchange market is given below Spot and Forward Exchanges Spot Market The term spot exchange refers to the class of foreign exchange transaction which requires the immediate delivery or exchange of currencies on the spot. In practice the settlement takes place within two days in most markets. The rate of exchange effective for the spot transaction is known as the spot rate and the market for such transactions is known as the spot market.

Forward Market The forward transactions is an agreement between two parties, requiring the delivery at some specified future date of a specified amount of foreign currency by one of the parties, against payment in domestic currency be the other party, at the price agreed upon in the contract. The rate of exchange applicable to the forward contract is called the forward exchange rate and the market for forward transactions is known as the forward market. The foreign exchange regulations of various countries generally regulate the forward exchange transactions with a view to curbing speculation in the foreign exchanges market.

In India, for example, commercial banks are permitted to offer forward cover only with respect to genuine export and import transactions. Forward exchange facilities, obviously, are of immense help to exporters and importers as they can cover the risks arising out of exchange rate fluctuations be entering into an appropriate forward exchange contract. With reference to its relationship with spot rate, the forward rate may be at par, discount or premium. If the forward exchange rate quoted is exact equivalent to the spot rate at the time of making the contract the forward exchange rate is said to be at par.

The forward rate for a currency, say the dollar, is said to be at premium with respect to the spot rate when one dollar buys more units of another currency, say rupee, in the forward than in the spot rate on a per annum basis. The forward rate for a currency, say the dollar, is said to be at discount with respect to the spot rate when one dollar buys fewer rupees in the forward than in the spot market. The discount is also usually expressed as a percentage deviation from the spot rate on a per annum basis. The forward exchange rate is determined mostly be the demand for and supply of forward exchange.

Naturally when the demand for forward exchange exceeds its supply, the forward rate will be quoted at a premium and conversely, when the supply of forward exchange exceeds the demand for it, the rate will be quoted at discount. When the supply is equivalent to the demand for forward exchange, the forward rate will tend to be at par. Futures While a focus contract is similar to a forward contract, there are several differences between them. While a forward contract is tailor made for the client be his international bank, a future contract has standardized features the contract size and maturity dates are standardized.

Futures cab traded only on an organized exchange and they are traded competitively. Margins are not required in respect of a forward contract but margins are required of all participants in the futures market an initial margin must be deposited into a collateral account to establish a futures position. Options While the forward or futures contract protects the purchaser of the contract fro m the adverse exchange rate movements, it eliminates the possibility of gaining a windfall profit from favorable exchange rate movement.

An option is a contract or financial instrument that gives holder the right, but not the obligation, to sell or buy a given quantity of an asset as a specified price at a specified future date. An option to buy the underlying asset is known as a call option and an option to sell the underlying asset is known as a put option. Buying or selling the underlying asset via the option is known as exercising the option. The stated price paid (or received) is known as the exercise or striking price. The buyer of an option is known as the long and the seller of an option is known as the writer of the option, or the short.

The price for the option is known as premium. Types of options: With reference to their exercise characteristics, there are two types of options, American and European. A European option cab is exercised only at the maturity or expiration date of the contract, whereas an American option can be exercised at any time during the contract. Swap operation Commercial banks who conduct forward exchange business may resort to a swap operation to adjust their fund position. The term swap means simultaneous sale of spot currency for the forward purchase of the same currency or the purchase of spot for the forward sale of the same currency.

The spot is swapped against forward. Operations consisting of a simultaneous sale or purchase of spot currency accompanies by a purchase or sale, respectively of the same currency for forward delivery are technically known as swaps or double deals as the spot currency is swapped against forward. Arbitrage Arbitrage is the simultaneous buying and selling of foreign currencies with intention of making profits from the difference between the exchange rate prevailing at the same time in different markets Forward Contract Forward contracts are typical OTC derivatives.

As the name itself suggests, forward are transactions involving delivery of an asset or a financial instrument at a future date. One of the first modern to arrive contracts as forward contracts ere known was agreed at Chicago Boar of Trade in March 1851 for maize corn to be delivered in June of that year. Characteristics of forward contracts The main characteristics of forward contracts are given below; They are OTC contracts Both the buyer and seller are committed to the contract. In other words, they have to take deliver and deliver respectively, the underlying asset on which the forward contract was entered nto. As such, they do not have the discretion as regards completion of the contract. Forwards are price fixing in nature. Both the buyer and seller of a forward contract are fixed to the price decided upfront. Due to the above two reasons, the pay off profiles of the borrower and seller, in a forward contract, are linear to the price of the underlying. The presence of credit risk in forward contracts makes parties wary of each other. Consequently forward contracts are entered into between parties who have good credit standing. Hence forward contracts are not available to the common man.

Determining Forward Prices In principle, the forward price for an asset would be equal to the spot or the case price at the time of the transaction and the cost of carry. The cost of carry includes all the costs to be incurred for carrying the asset forward in time. Depending upon the type of asset or commodity, the cost of carry takes into account the payments and receipts for storage, transport costs, interest payments, dividend receipts, capital appreciation etc. Thus Forward price = Spot or the Cash Price + Cost of Carry Merchant Rate

The foreign exchange dealing of a bank with its customer is known as ‘ merchant business’ and the exchange rate at which the transaction takes place is the merchant rate. The merchant business in which the contract with the customer to buy or sell foreign exchange is agreed to and executed on the same day is known as ready transaction or cash transaction. As in the case of interbank transactions a value next day contract is deliverable on the next business day and a ‘ spot contract’ is deliverable on the second succeeding business day following the date of the contract. Most of the transactions with customers are on ready basis.

In practice, the term ‘ ready’ and ‘ spot’ are used synonymously to refer to transactions concluded and executed on the same day. Foreign Exchange Transactions Foreign exchange dealing is a business in which foreign currency is the commodity. It was seen earlier that foreign currency is not a legal tender. The US dollar cannot be used for settlement of debts in India; nevertheless, it has value. The value of US dollar is like the value of any other commodity. Therefore, the foreign currency can be considered as the commodity in foreign exchange dealings. Purchase and Sale transactions Any trading has two aspects (i) Purchase (ii) sale.

A trader has to purchase goods from his suppliers which he sells to his customers. Likewise the bank (which is authorized to deal in foreign exchange) purchases as well as sells its commodity the foreign currency. Two points need be constantly kept in mind while talking of a foreign exchange transaction: 1. The transaction is always talked of from the banks point of view 2. The item referred to is the foreign currency. Therefore when we say a purchase we implied that (i) (ii) (i) (ii) the bank has purchased it has purchased foreign currency the bank has sold it has sold foreign currency.

Similarly, when we sale a sale, we imply that In a purchase transaction the bank acquired foreign currency and parts with home currency. In a sale transaction the bank parts with foreign currency and acquires home currency. Exchange Quotations We have seen that exchange rates can be quoted in either of the two ways; (a)direct quotation (b) indirect quotation. The quotation in which exchange rate is expressed as the price per unit of foreign currency in terms of the home currency is k known as ‘ Home currency quotation’ or ‘ Direct quotation’.

It may be noted that under direct quotation the number of units of foreign currency is kept constant and any change in the exchange rate will be made by changing the value in term of rupees. For instance, US dollar quoted at Rs. 48 may be quoted at Rs 46 or Rs. 49 as may be warranted. The quotation in which the unit of home currency is kept constant and the exchange rate is expressed as so many unit of foreign currency is known as ‘ Foreign Currency quotation’ or Indirect quotation’ or simply ‘ Currency Quotation’.

Under indirect quotation, any change in exchange rate will be effected by changing the number of units of foreign currency. Basis for Merchant Rates When the bank buys foreign exchange from the customer, it expects to sell the same in the interbank market at a better rate and thus make a profit out of the deal. In the interbank market, the bank will accept the rate as dictated by the market. It can, therefore, sell foreign exchange in the market at the market buying rate for the currency concerned. Thus the interbank buying rate forms the basis for quotation of buying rate by the bank to its customer.

Similarly, when the bank sells foreign exchange to the customer, it meets tele commitment by purchasing the required foreign exchange from the interbank market. It can acquire foreign exchange from the market at the market selling rate. Therefore the interbank selling rate forms the basis for quotation of selling rate to the customer buy the bank. The interbank rate on the basis of which the bank quotes its merchant rate is known as the base rate. Exchange Margin If the bank quotes the base rate to the customer, it makes no profit. On the other hand, there are administrative costs involved. Further the deal with the ustomer takes p-lace first. Only after acquiring or selling the foreign exchange from to the customer, the bank goes to the interbank market to sell or acquire the foreign exchange required to cover the deal with the customer. An hour or two might have lapsed by this time. The exchange rates are fluctuating constantly and by the time the deal with the market is concluded, the exchange rate might have turned adverse to the bank. Therefore sufficient margin should be built into the rate to cover the administrative cost, cover the exchange fluctuation and provide some profit on the transaction to the bank.

This is done by loading exchange margin to the base rate. The quantum of margin that is built into the rate is determined by the bank concerned, keeping with the market trend. Principal types of Buying Rates In a purchase transaction the bank acquires foreign exchange from the customer and pays him in Indian rupees. Some of the purchase transactions result in the bank acquiring foreign exchange immediately, while some involve delay in the acquisition of foreign exchange.

For instance, if the bank pays a demand drawn on it by its correspondent bank, there is no delay because the foreign corresponded bank would already have credited the nostro account of the paying bank while issuing the demand draft. On the other hand, if the bank purchases on ‘ On demand’ bill from the customer, it has first to be sent to the draws place for collection. The bill will be sent to the correspondent bank for collection. The correspondent bank will present the bill to the drawee. Depending upon the tine of realization of foreign exchange by the bank, two types of buying rates are quoted in India.

They are (i) (ii) TT Buying Rate Bill Buying Rate (i)TT Buying Rate (TT stands for Telegraphic Transfer) This is the rate applied when the transaction does not involve any delay in realization of the foreign exchange by the bank. In other words, the nostro account of the bank would already have been credited. The rate is calculated by deducting from the interbank buying rate the exchange margin as determined by the bank. Though the name implies telegraphic transfer, it is not necessary that the proceeds of the transaction are received by telegram.

Any transaction where no delay is involved in the bank acquiring the foreign exchange will be done at the TT rate. Transaction where TT rate is applied is; 1. Payment of demand drafts, mail transfers, telegraphic transfers, etc drawn on the bank where banks nostro account is already credited 2. Foreign bills collected. When a foreign bill is taken for collection, the bank pays the exporter only when the importer pays for the bill and the banks nostro account abroad is credited 3. Cancellation of foreign exchange sold earlier.

For instance, the purchaser of a bank draft drawn on New York may later request the bank to cancel the draft and refund the money to him. In such case, the bank will apply the TT buying rate to determine the rupee amount payable to the customer. (ii)Bill Buying Rate This is the rate to be applied when a foreign bill is purchased. When a bill is purchased, the rupee equivalent of the bill value is paid to the exporter immediately. However, the proceeds will be realized by the bank after the bill is presented to the drawee at the overseas centre. In case pf a usance bill, the proceeds will be realized n the due date of the bill which includes the transit period and the usance period of the bill. Principle types of selling rates When a bank sells foreign exchange it receives Indian rupees from the customer and parts with foreign currency. The sale is affected by issuing a payment instrument on the correspondent bank with which it maintains the nostro account. immediately on sale, the bank buys the requisite foreign exchange from the market and gets its nostro account credited with the amount so that when the payment instrument issued buy its is presented to the corresponded bank it can be honored by debit to the nostro account.

However, depending upon the work involved, viz. , whether the sale involves handling of documents by the bank or not, two types of selling rates are quoted in India, they are 1. TT selling rate 2. Bills selling rate 1. TT Selling Rate This is the rate to be used for all transactions that do not involve handling of documents by the bank. Transactions for which this rate is quoted are: (1) Issue of demand drafts, mail transfers, telegraphic transfer, etc. , other than for retirement of an import bill. (2) Cancellation of foreign exchange purchased earlier.

For instance, when an export bill purchased earlier is returned unpaid on its due date, the bank will apply the TT selling rate for the transaction. 2. Bills Selling Rate This rate is to be used for all transactions which involve handling of document by the bank: for example, payment against import bills. The bills selling rate is calculated by adding exchange margin to the TT selling rate. That means the exchange margin enters into the bills selling rate twice, once on the interbank rate and again on the TT selling rate. Ready Rates Based on Cross Rates

The exchange rates for other currencies are quoted to customers based on the rates for the currency concerned prevailing in international foreign exchange markets like London, Singapore and Hong Kong. There rates are available in terms of US dollar. They have to be converted into rupee terms before quoting to the customers. We shall first examine how exchange rate are quoted in international markets and then we shall see how these rates are used for quoting rates for currencies other then US dollar in India. Exchange quotations in International Markets

In International markets, barring few exceptions, all rates are quoted in term of US dollar. For instance, at Singapore Swiss franc may be quoted at 1. 5425/5440 and Japanese yen at 104. 67/70. This should be understood as; USD 1 = CHF 1. 5425 ??? 1. 5440 USD 1 = JPY 104. 67 ??? 104. 70 In interpreting an international market quotation, we may approach from the variable currency or the base currency, viz. , the dollar. For instance we may take a transaction in which Swiss franc are received in exchange for dollars as (a) Purchase of Swiss francs against Dollar b) Sale of Dollar against Swiss francs. The quotation for Swiss franc is CHF 1. 5425 and CHF 1. 5440 per Dollar. While buying dollar the quoting bank would part with fewer francs per dollar and while selling dollars would require as many francs as possible. Thus, CHF 1. 5425 is the dollar buying rate and DEM 1. 5440 is the dollar selling rate. It may be observed that when viewed from dollar, the exchange quotation partakes the character of a direct quotation and the maxim ‘ Buy low: Sell high’ is applicable. Forward Margin/Swap Points.

Dollar/Foreign Currency Quotation At Singapore market dollar may be quoted against Deutsche mark and French franc as follows: Swiss Franc Yen Spot

104. 67/70 1 month forward 17/16 2 months forward 30/29 70/80 50/60 1. 5425/40 Japanese The forward margin (also called swap margin or swap points) is quoted in terms of points. A point is the last decimal place in the exchange quotation. Thus in a four digit quotation, a point is 0. 0001. In a two decimal quotation it is 0. 01 As against Swiss franc, the forward margin for dollar is CHF 0. 0050/0. 0060.

Since the order in which the forward margin is ascending, forward dollar is at premium. Premium is added to the spot rate to arrive at the forward rates, both in respect of purchase and sale transactions. Based on the data given above, the forward rates for dollar against Swiss francs are arrived at as follows; Dollar Buying 1 month forward 2 months forward CHF 1. 5475 CHF 1. 5495 Dollar Selling 1. 5500 1. 5520 Foreign Currency/Dollar Quotation Let us assume the following exchange rates are prevailing Pound sterling Spot 1 month forward 2 months forward 1. 326/48 50/53 90/93 Euro 0. 9525/35 65/62 84/82 Against dollar, the forward pound ??? sterling is at premium. Premium should be added to the spot rate to arrive at the forward rate. Thus the forward rates for pound sterling are as follows. Pound Sterling Buying 1 month forward 2 months forward USD 1. 4376 USD 1. 4416 Pound sterling Selling 1. 4401 1. 4441 Cross Rates and Chain Rule In India, buying rates are calculated on the assumption that the foreign exchange acquired is disposed of abroad in the international market and the proceeds realized in US dollars.

The US dollars thus acquired would be sold in the local interbank market to realize the rupee. For example, if the bank purchased a CHF 10, 000 bill it is assumed that it will sell the Swiss francs at the Singapore market and acquire US dollars there. The US dollars are then sold in the interbank market against Indian rupee. The bank would get the rate for US dollars in terms of Indian rupees in India. This would be the interbank rate for US dollars. It would also get the rate for US dollars in terms of Swiss franc at the Singapore market.

The bank has to quote the rate to the customer for Swiss franc in terms of Indian rupees. The fixing of rate of exchange between the foreign currency and Indian rupee through the medium of some other currency is done by a method known as ‘ Chain Rule’. The rate thus obtained is the ‘ Cross rate’ between these currencies. Role of FEDAI in Foreign Exchange Authorized Dealers in Foreign Exchange (Ads) have formed an association called foreign Exchange Dealers Association of India (FEDAI) in order to lay down certain terms and conditions for transactions in. Foreign Exchange Business. Ad has to given an undertaking to Reserve Bank of India to abide by the exchange control and other terms and conditions introduced by the association for transactions in foreign exchange business. Accordingly FEDAI has evolved various rules for various transactions in order to protect the interest of the exporters, importers general public and also the authorized in dealers. FEDAI which is a company registered under Section 25 of the companies Act, 1956 has subscribed to the 1. Uniform customs and practice for documentary credits (UCPDC) 2.

Uniform rules for collections(URC) 3. Uniform rules for bank to bank reimbursement. Various rules of FEDAI Rules No 1. of FEDAI deals with hours of business of banks which is the normal banking hours of ADs. On Saturdays no commercial transaction in foreign exchange will be conducted except purchase/sale of traveler’s cheques and currency notes and transactions where exchange rates have been already fixed. Rules No. 2 deals with export transactions export bills purchased/discounted negotiation, export bills for collection export letters of credit, etc.

Application of Rates of Crystallization of Liabilities and Recovers 1. Foreign currency bill will be purchased/ negotiation / discounted at the Authorized Dealers current bill purchase rate or at the contract rate. 2. Exporters are liable for the repatriation of proceeds of the export bills negotiated/purchased/discounted sent for collection through the Authorized Dealers. They would transfer the exchange risk to the exporter by crystallizing, the foreign currency liability into Rupee liability on the 30th day after the transit period in case of unpaid demand bills.

In case of unpaid usance bills crystallization will take place on the 30th day after notional due date or actual due date. Notional due date is arrived at by adding transit period, usance period and grace period if any to the date of purchase/discount/negotiation. In case 30th day happens to be a holiday or Saturday, the export bill will be crystallized on the next working day. For crystallization into rupee liability the bank will apply the TT selling rate on the date of crystallization the original buying rate whichever is higher.

Normal Transit period comprises usual time involved from negotiation/purchase/discount of documents till receipt of proceeds there of in the Nostro account. It is not, as is commonly misunderstood, the time taken for the arrival of goods at the destination. CRYSTALLISATION OF IMPORT BILLS (RULES 30 All foreign currency import bills drawn under letter of credit shall be crystallized into Rupee liability on the 10th day from the date of c

eceipt of documents at the letter of credit opening bank in the case of demand bills and on the due date in the case of usance bills.

In case the 10th day or due date falls on a holiday or Saturday the importers liability should be crystallized, into Rupee liability on the next working day. INTEREST ON EXPORT BILLS/NORMAL TRANSIT PERIOD Concessional rate of interest on export bills is linked to the concept of normal transit period and notional due date. Normal transit period comprised the average period normally in involved from the date of negotiation/purchase/discount till the receipt of bill proceeds in the Nostro account of the bank. Normal Transit period is not to be confused with the time taken for the arrival of goods at the destination.

In case of bills payable ‘ at sight’ or ‘ on demand’ basis Concessional rate of interest ad directed by the RBI on export bill is applicable for the normal transit period in case of all foreign currency bills. In case of usance bills, Concessional rate of interest as directed by the RBI on export bills is applicable for the normal transit period plus usance period. Thus a foreign currency bill payable for example at 60 days after sight will be eligible for Concessional interest rate for 60 days usance plus the normal transit period of 25 days, i. . , a total number of 85 days. Normal Transit period for purpose Of all bills in foreign Currencies INTEREST ON IMPORT BILLS a. Bills negotiated under import letter of credit shall carry domestic commercial rate of interest as applicable to advances prescribed by Reserve Bank of India from time to time and shall be recovered from the date of debit to the AD’s Nostro account to the date of crystallization/retirement whichever earlier. B.

From the dates of rystallization up to the date of retirement the bills shall carry the overdue rate of interest as specified by Reserve Bank of India from time to time. EXCHANGE CONTRACTS Exchange contracts shall be for definite amount unless date of delivery is fixed and indicated in the contract, the option period of delivery should be specified as. a. The option of delivery shall not exceed beyond, one month. The merchant whether a buyer or a seller will have the option of delivery. i. Early delivery: If a bank accepts or gives early delivery the bank shall recover/pay swap difference if any. i. Extension: forward contract either short term or long term contracts where extension is sought by the customers (or as rolled over) shall be cancelled (at TT selling or buying rate as on the date of cancellation) and re book only at (current rate of exchange). The difference between the contracted rate and the 25 days. rate at which the contract is cancelled should be recovered from/paid to be customer at the time of extension. Such request for the extension should be made on or before the maturity date of the contract. ii. Cancellation: In the case of cancellation of a contract at the request of the customer, the bank shall recover/pay as the case may be difference between the contract rate and the rate at which the cancellation is effected. b. Rate at which cancellation to be effected. i. Purchase contract shall be cancelled at the contracting banks spot TT selling rate current on the dater of cancellation. ii. iii. Sale contracts shall be cancelled at the contracting banks spot TT buying rate current on the date of cancellation.

Where the contract is cancelled before maturity the appropriate TT rate shall be applied. SWAP Cost: a. If any shall be recovered from the customers under advise to him. b. In the absence of any instruction from the customer contracts which have matured shall on the 15th day from the date of maturity be automatically cancelled. In case the 15th day falls on a Saturday or holiday the contract will be cancelled on the succeeding working day. In the above case the customer will not be entitles to the exchange different if any since the contract is cancelled on account of his default.

In case of delivery subsequent to automatic cancellation the appropriate current rate prevailing on such delivery date shall be applied. Payment of SWAP gains to the customer will normally be made at the end of the swap period. Outlay and inflow of funds: a. Interest at not below the prime lending rate of the respective bank on outlay of funds by the bank for the purpose of covering the swap shall be recovered in addition to be swap cost, in case early delivery of purchase or sale contracts and early realization do export bill negotiated.

The amount of funds out laid shall be arrived at by calculating the difference between the original contracted rate and the rate at which swap could be arranged. B. If such a swap leads to inflow of funds the amount shall be paid at the discretion of banks to the customer at the appropriate rate applicable for the term deposits the period for which the funds remained with the bank. C. Banks will levy a minimum charge of Rs. 250 for every request from a customer for early delivery, extension or cancellation of a contract. Reserve Bank of India Act, 1934

The RBI of India performs both the traditional functions of a central bank and a variety of developmental and promotional functions. The RBI Act, 1934, confers upon it the powers to act as not issuing authority, banker’s bank and banker to the Government. Reserve Bank as Note Issuing Authority The Currency of our country consists of one rupee notes and coins (including subsidiary coins) issued by the Government of India and bank notes issued by the Reserve Bank. As required by section 38 of the RBI act, Government puts into circulation one rupee coins and notes through Reserve Bank only.

The Reserve Bank has the sole right to issue bank notes in India. The notes issued by the Reserve Bank and the one rupee notes and coins issued by the Government are unlimited legal tender. Reserve Bank also bears the responsibility of excha