**UNIT – II International Financial Management**

**Foreign Exchange**

Foreign exchange refers to all the currencies of the rest of the world other than the domestic currency of the country. For example, in India, US dollar is the foreign exchange.

**Foreign exchange rate:** The rate at which one currency is exchanged for another is called Foreign Exchange Rate.

In other words, the foreign exchange rate is the price of one currency stated in terms of another currency. For example, if one U.S dollar exchanges for 60 Indian rupees, then the rate of exchange is 1$ = Rs. 60 or 1 Rs = 1/60 or 0.0166 U.S. dollar.

**Foreign exchange market:** Foreign exchange market is not a physical place it is in network of banks foreign exchange brokers and dealers whose function is to bring Buyers and sellers together. The leading financial centers are in London, New York, Paris, Amsterdam, Tokyo, Milan etc. Because of the time difference between countries and because of the nature of foreign currency transactions, the foreign exchange market can be considered to be a 24 hour market. Business hours overlap around the world. When trading and banking hours close in one country, another country will still be trading. Banks in Sydney, Tokyo, Hong Kong and Singapore begin trading at about the time most traders in San Francisco are closing for the previous day. Because of our advantageous location, India is in a position to trade both with Eastern and western financial centres even during the normal working hours.

It is in foreign exchange market where money denominated in one currency is bought and sold with money denominated in another currency. The primary purpose of the foreign exchange market is to permit transfer of purchasing power denominated in one currency to another. For example, a Japanese exporter sells automobiles to Indian dealer in Rupees and an Indian manufacturer sells food products to a Japanese company for Yen. The Japanese exporter will like to receive payment in Yen, while the Indian exporter will require the payment in Rupees.

**Participants in the foreign exchange market :**

The participants in foreign exchange market are retail customers, commercial banks, foreign exchange brokers and the central banks.

1. Retail customers: Retail customers include a long list of exporters, importers, hedgers, speculators, borrowers, investors, Travellers, MNCs, PSUs and others.
2. Commercial banks: The commercial banks have been authorized by the RBI to deal in foreign exchange. They are referred to as Authorized dealers/authorized persons. They may buy and sell foreign exchange for their customers. Traders over the countries do not transact directly but usually with a bank in his own country. For this purpose, banks hold large amount of foreign exchange.
3. Foreign exchange brokers : They act as agents who facilitate trading. They actively and constantly monitor exchange rates offered by international banks.
4. Central bank: Another important player in foreign exchange market is the central bank of various countries. Central banks frequently intervene in the market to bring about stability in the exchange rate or to maintain a target rate.

**Sources of supply and demand for foreign exchange :**

Sources of supply:

1. Export of goods and services. The banking, insurance and transport services also earn foreign exchange through the services rendered by them to their foreign customers.

2. Foreign direct investments: Direct and portfolio investments and foreign deposits by the residents earn foreign exchange in terms of dividends, profits, interest, etc.

3. Foreign tourists: Tourists from abroad spend lot of money which adds to the foreign exchange earnings of the country.

4. Private remittances: Persons who are employed outside their countries usually send foreign currencies to their relatives in their home countries adding to the foreign exchange supply.

5. Foreign missions: NGOs from abroad spend lots of money in the countries where they are located.

6. Foreign aids and loans: A major source of foreign exchange inflow comes from foreign aids or foreign assistance in the form of loans, grants, etc.

7. Repayment of loans and interest payments by foreigners is another source of foreign exchange.

DEMAND FOR FOREIGN EXCHANGE :

1. Import of goods and services - Importers demand huge amounts of foreign exchange.

2. Services rendered by foreign banking, insurance and transport services.

3. Foreign investment in domestic country must be paid dividends, profits and interest.

4. Foreign tour by residents, for pleasure trip, education, medical treatment or business may require huge amounts of foreign exchange.

**TYPES OF FOREIGN EXCHANGE RATES:**

Exchange rate is the proportion at which one currency can be exchanged for another. There are two types of exchange rates -- fixed and floating rates. Fixed exchange rates are those in which the country’s currency is matched with another single currency. Floating exchange rates allow currencies to fluctuate in the foreign exchange markets. There are two types of floating exchange rates -- fixed float and managed float.

Free Float

The free float exchange rate system is one that has no intervention from the government. The demand and supply forces interact and then the rate of exchange is determined. Under this mechanism, there is a high risk of volatility. One currency may appreciate or depreciate steeply, and the exchange rate is similarly affected. This mechanism is called the “free float” or the “clean float.”

Managed Float

This method is a variation on the free float mechanism. All countries have trade links with one another, and international currencies fluctuate daily. Many countries of the world use the float system to determine the rates of exchange. Here, the government and central banks of the country intervene and help to set the exchange rates. These authorities try to smooth out the fluctuations and volatility of the currencies. This system is called the “managed float” or the “dirty float.”

Spot rates and forward rates:

Spot rates are rates quoted in the spot market where currencies are traded for immediate delivery – which is actually within 2 business days after the transaction.

Forward rates are quoted for forward contracts made to buy or sell currencies for future delivery. Forward rate is a price quotation, which is based on expectations for the currency to rise or fall versus its spot price. Forward rate values may [fluctuate](https://www.investopedia.com/ask/answers/08/how-often-to-exchange-rates-fluctuate.asp) due to changes in expectations for future interest rates in one country versus another. Forward rates may be for future delivery of 30 days, 90 days and 180 days.

Forward exchange rate is generally expressed in relation to spot rate ruling at the time when forward rate is quoted. Forward quotations are made in one of the following ways: i) As the outright forward rate; ii) As a premium on the spot rate or a discount from it, referred to as forward differential. There are three possible relationships between spot rates and forward rates. The forward rate can be at par with the spot rate. It can be at premium over the spot rate or might be at a discount from the spot rate. Traders refer to premium as forward pick up and discount as forward mark downs.

Swaps:

 A swap transaction is a simultaneous purchase and sale of a certain amount of foreign currency for two different dates. In finance, a currency swap, also known as cross-currency swap, is a legal contract between two parties to exchange two currencies at a later date, but at a predetermined exchange rate. Generally the original trade is in the form of spot exchange and the second trade is in the form of forward exchange. Such swaps are called as spot-forward swaps. The trader buys or sells on the spot market, while simultaneously selling or buying on the forward market. By this act, the original exchange is reversed. There are also forward-forward swaps. They involve buying and selling with the offsetting contracts being forward agreements. For example, one can sell a currency one month forward and buy the same three months forward at the pre specified rates. Banks can resort to swap transactions when there are mismatches between their holdings and requirements.

**Two Way Quotations:**

 Typically, the quotation in the interbank market is a two – way quotation. It means the rate quoted 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. 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. 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 2.0762 per Rs.100 while selling dollars. In other words, the rule applied is: ―Buy high: Sell low. The buying rate is also known as the bid rate and selling rate as the ask 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, it is known as 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.

Forwards:

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 after 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.

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 cheaper than its spot rate. The rate for a currency may be costlier or cheaper than its 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 currency 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 than 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 USD 1 = Rs.48.4000/4200

Spot/February 2000/2100

Spot/March 3500/3600

**Factors affecting foreign exchange rates**

1. Inflation Rates

Changes in market inflation cause changes in currency exchange rates. A country with a lower inflation rate than another's 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.

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