(1)

Date:— 26/4/2020	Degree Part–II (Hons.)
Content Writer:—	Paper–IV
Dr. Akhay Kumar Pathak	Content of the Paper:—
Deptt. of Economics,	International Economics
Marwari College,	Module:– 5
Darbhanga (LNMU)	

TOPIC :— FOREIGN EXCHANGE MARKET AND EXCHANGE RATE

Scanned with CamScanner

Foreign exchange market is an institutional arrangement for buying and selling of foreign currencies. Exporters sell the foreign currencies and importers buy them. The foreign exchange market is merely a part of the money market in the financial centres. It is a place where foreign moneys are bought and sold. The buyers and sellers of claim on foreign money and the intermediaries together constitute a foreign exchange market. It is not restricted to any given country or geographical area. Hence, the foreign exchange market is the market for a national currency anywhere in the world, as the financial centres of the world are united in a single market.

There is a wide variety of dealers in the foreign exchange market. The most important among them are banks. Banks dealing in foreign exchange have branches in different countries. Through their branches and correspondents, the services of such banks, usually called "Exchange Banks" are available all over the world. These banks discount and sell foreign bills of exchange, issue bank drafts, offer telegraphic transfers and other credit instruments and discount and collect amounts on the basis of such documents. Other dealers in foreign exchange are bill brokers who help sellers and buyers in foreign bills to come together. They are intermediaries and they

Scanned with CamScanner

are not direct dealers. Acceptance houses are another class of dealers in foreign exchange. They help to effect foreign remittances by accepting bills on behalf of customers. The central bank and treasury of a country are also dealers in foreign exchange. Both may intervene in the market occasionally.

Functions of Foreign Exchange Market :-

Following are the important functions of foreign exchange market :-

(I) Transfer Function :-

The basic function of the foreign exchange market is to facilitate the conversion of the currencies into another, that is, to accomplish transfers of purchasing power between two countries. In performing the transfer function, the foreign exchange market carries out payments internationally by clearing debts in both directions simultaneously, analogous domestic clearings.

(II) Credit Function :-

Another function of the foreign exchange market is to provide credit, both national and international, to promote foreign trade. Obviously, when foreign bills of exchange are used in international payments, a credit for about three months, till their maturity, is required.

Scanned with CamScanner

Date ___/___/______

(iii) Hedging Function:-

An important function of foreign exchange market is to hedge foreign exchange risks. Hedging means the avoidance of a foreign exchange risk. In a foreign exchange market, when exchange rate change in terms of one country to another, there may be a gain or loss to the party concerned. Under this condition, a person or a firm undertakes a great exchange risk if there are huge amount of net claims or net liabilities which are to be met in foreign money. Exchange rate as such should be avoided or reduced. For this the exchange market provides facilities for hedging anticipated or actual claims or liabilities through forward contracts in exchange. A forward contract which is normally for three months is a contract to buy or sell foreign exchange against another currency at some fixed date in the future at a price agreed upon now. No money passes at the time of the contract. But the contract makes it possible to ignore any likely changes in exchange rate. The existence of a forward market thus makes it possible to hedge an exchange position.

Rate of Exchange:-

The rate of exchange is nothing but the value or price of a country's currency expressed in terms of a foreign currency. In other words, the rate at which

Maharaza

Scanned with CamScanner

the currencies of two nations are exchanged for each other is called the rate of exchange. In foreign exchange market, however, at any one point of time, there hardly exists a unique rate of exchange. Following are the kinds of rate of exchange :-

(I) Spot and Forward Exchange Rates :-
Spot rate of exchange and forward rate of exchange in terms of domestic money payable refers to the price of foreign exchange in terms of domestic money payable for the immediate delivery of a particular foreign currency. It is, thus, a day to day rate. On the other hand, forward rate of exchange refers to the price at which a transaction will be consummated at some specified time in the future. A forward exchange market functions side by side with a spot exchange market.

(II) Real Exchange Rate :-
The real exchange rate is the nominal exchange rate adjusted for the relative price levels variation. A higher degree of inflation rate in home country implies a lower real exchange rate and vice versa. When the real exchange rate declines, it means a decrease in international competitiveness of the country. Variability in inflation rates leads to changes in real exchange rates.

Scanned with CamScanner