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Foreign Exchange Market

Foreign Exchange

- What is Foreign exchange?

Ans: Foreign exchange is the exchange of one currency for another or the conversion of one currency into another currency.

The term foreign exchange is usually abbreviated as Forex.

Foreign Exchange Market

- Foreign Exchange Market is a global, decentralised or over

the counter market for the trading of currencies.

Here participants are able to buy, sell , exchange, speculate on currencies. The buyer and seller include individual,firms, foreign exchange broker, commercial bank and the central bank.

Like any other market, foreign exchange market is a system, not a place.

Types of Foreign Exchange Market

- Spot market
- Forward market
- Future market
- Option market
- Swaps

Spot market

The spot market or cash market is a public financial market in which financial instruments or commodities are traded for immediate delivery.

In finance, a spot contract, spot transaction or simply spot , is a contract of buying or selling commodity, security or currency for settlement (payment and delivery) on the spot date which is normally two business days after the trade date.

The settlement price (or rate) is called spot price (or spot rate)

Forward Market

- Forward market :-A market in which foreign exchange is bought and sold for future delivery is known as forward market.
- Forward contract:- A forward contract is an agreement between two persons for the purchase and sale of a commodity or financial assets at a specified price (known as forward rate) to be delivered at a specified future date.
- A forward allows one to lock in an exchange rate today for a future payment or receipt, thereby eliminating rate risk.Forward contact are usually available for periods up to 12 month.

Advantages of Forward Contract

- It can be used to hedge or protect oneself from the price fluctuations on the future commitment date to extent of 100%.
- The up front fees or margins are not applicable to forward contract and hence no initial costs.

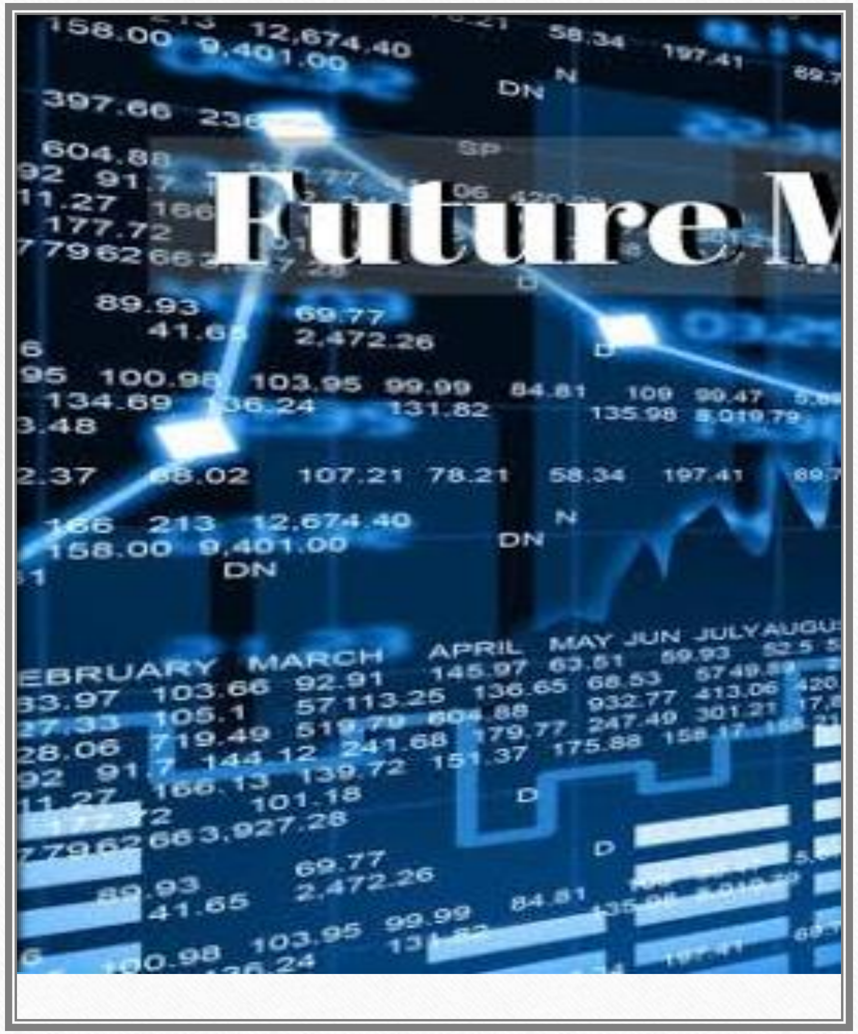
Disadvantages of Forward contact

- Forward contracts are not performance guaranteed. Hence involve counter party risk.
- The investors cannot derive any gain from favorable price movement either before or on delivery date.
- Forward contract are not traded in the secondary market, Hence there is no ready liquidity.

Future Market

Future Market:- The future market is a centralized market for trading future contracts.

Future Contract:- A future contract is an agreement between a seller and a buyer which requires the seller to deliver to the buyer a specified quantity of security, commodity or foreign exchange at a fixed time in future at a price agreed to at the time of entering the contract .



Why futures?

Future contracts are bought and sold for many reasons.

Individuals deal in future contracts to speculate about the future price of the asset or commodity underlying the futures contract.

Corporates enter into future contract to eliminate the risk exposure occurring due to changes in the price of commodity.

Fund managers use futures as a more economical way of achieving their portfolio goals.

Speculators deals in futures to benefit from price fluctuations while hedgers seek to protect themselves.

Characteristics of futures

- Future contacts are traded in organized exchanges with a designated location for futures trading. This provide instant liquidity as futures contract can be sold and bought anytime like in a stock market.
- The futures contracts are standardized in the sense that the price, the quantity and the date of maturity is fixed by the exchange in which they are traded.

Types of futures:- ***futures may be broadly classified into commodity and financial futures.***

Commodity Future:- like tea, coffee, cocoa , aluminium etc

Financial future :- Financial instruments like Treasury bill, currency or stock index

Options Market

An option is a contract in which the seller (writer) of the option grants the buyer of the option the right to purchase from or sell to the writer a designated instruments for a specified price within a specified period of time.

In other words, an option is a contract that gives the holder the right, but not the obligation, to buy(call) or sell(put) a specified underlying instruments at a fixed price before, or at a future date.

The option holder has to compansate the writer (the issuer of the instrument) for this right, and the cost borne is called the premium or the option price .

If the option contains provision to the effect that it can be exercised any time **before the expiry** of the contract, it is termed as an **American contract.**
If it can be exercised only **on the expiry date,** it is termed as **European contract.**

Types of options

- Currency call option:- grant it's owner the right but not the obligation to buy a specified currency at a specified price within a specified time.
- Currency put option:- grant it's owner the right but not the obligation to sell a specified currency at a specified price within a specifiedtime.
- Stock option:- an option on a stock is called stock option.
- Bond option:- an option on a bond is called bond option.
- Stock index option.
- Multi currency option.
- American option and European option

Why options?

- Unlike a foreign exchange forward, the option doesn't obligate the buyer to deliver currency on the settlement date
- Foreign exchange options are ideal for hedging exposures in which the amount or the timing of exposure are uncertain
- Foreign exchange options allows you to protect against unfavorable currency moves while retaining the ability to participate in favorable moves.

Swaps

Swaps :- swap in finance means an exchange of one obligation with another. Financial swaps are a funds technique, which permit a borrower to access one market or instrument and exchange the liability to another market or instrument. Investors can exchange one type of Risk with another.

Swap allows the borrower to raise money in one market and to swap one interest rate structure for another (fixed to floating), or swap principal and interest from one currency to another.

Derivative

- Forward, future , options and swaps market are the forms of derivative market.
- Derivatives can be used for hedging, protecting against financial risk,or can be used to speculate on the movement of commodity or security prices, interest rates or the levels of Financial indices.

Thank you