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Role Foreign Exchange Market in today's Globalized Economy

Dr Mahesh.U.Daru (Ph.D, M.Com)

Keyword

Foreign Exchange, Foreign Exchange Market, International Finance, FEMA

Abstract

The Foreign exchange market plays significant role in the global trade in determining the strength of an economy and its growth. It is essential for international finance. The foreign exchange market India is growing very rapidly. The annual turnover of the market is more than $400 billion. This transaction does not include the inter-bank transactions. The Indian foreign exchange market consists of the buyers, sellers, market intermediaries and the monetary authority of India. The foreign exchange market is not limited by any geographical boundaries. It does not have any regular market timings, operates 24 hours 7 days week 365 days a year, characterized by ever-growing trading volume, exhibits great heterogeneity among market participants with big institutional investor buying and selling million of dollars at one go to individuals buying or selling less than 100 dollar.

Foreign Exchange Market in India operates under the Central Government of India and executes wide powers to control transactions in foreign exchange. The Foreign Exchange Management Act, 1999 or FEMA regulates the whole Foreign Exchange Market in India. This paper is about role foreign exchange market in economy. It also discussed about forex market, details about trading volume, market participants, different types of forex products.

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Authors Correspondence
Head of Accountancy Department
Smt C.D.J Rofel Arts & Smt I.S.R.A Rofel Commerce College , Vapi (Gujarat)

Introduction

After independence, FERA was introduced as a temporary measure to regulate the inflow of the foreign capital. But with the economic and industrial development, the need for conservation of foreign currency was felt and on the recommendation of the Public Accounts Committee, the Indian government passed the Foreign Exchange Regulation Act, 1973 and gradually, this act became famous as FEMA. Foreign Exchange Market in India operates under the Central Government of India and executes wide powers to control transactions in foreign exchange. The Foreign Exchange Management Act, 1999 or FEMA regulates the whole Foreign Exchange Market in India.

Before the introduction of this act, the foreign exchange market in India was regulated by the Reserve Bank of India through the Exchange Control Department, by the Foreign Exchange Regulation Act or FERA, 1947.

With the Economic and Industrial development, the need for conservation of foreign currency was urgently felt and on the recommendation of the Public Accounts Committee, the Indian government passed the Foreign Exchange Regulation Act, 1973 and gradually, this act became famous as FEMA. Till about 1992-93, government exercised absolute control on the exchange rate, export-import policy, FDI (Foreign Direct Investment) policy. "Hawala market" operating in India before liberalization. Before 1992, RBI was strictly controlling the exchange rate. This created a parallel foreign exchange market – a black market in foreign exchange popularly known as "Hawala Market". Hawala market is nothing but illegal foreign exchange market where forex trading happen at rates different than the rate mandated by the RBI. When the official rate "overvalues" the home currency, Hawala market starts operating.

Post liberalization, the Government of India, felt the necessity to liberalize the foreign exchange policy. Hence, Foreign Exchange Management Act (FEMA) 2000 was introduced. FEMA expanded the list of activities in which a person/company can undertake forex transactions. Through FEMA, government liberalized the export-import policy, limits of FDI (Foreign Direct Investment) & FII (Foreign Institutional Investors) investments and repatriations, cross-border M&A and fund raising activities.

Foreign exchange market

A foreign exchange market refers to buying foreign currencies with domestic currencies and selling foreign currencies for domestic currencies. Thus it is a market in which the claims to foreign moneys are bought and sold for domestic currency. Exporters sell foreign currencies for domestic currencies and importers buy foreign currencies with domestic currencies.

According to Ellsworth, "A Foreign Exchange Market comprises of all those institutions and individuals who buy and sell foreign exchange which may be defined as foreign money or any liquid claim on foreign money". Foreign Exchange transactions result in inflow & outflow of foreign exchange.

Functions of foreign exchange market

Foreign exchange is also referred to as forex market. Participants are importers, exporters, tourists and investors, traders and speculators, commercial banks, brokers and central banks. Foreign bill of exchange, telegraphic transfer, bank draft, letter of credit etc. are the important foreign exchange instruments used in foreign exchange market to carry out its functions. The Foreign Exchange Market performs the following functions.

1. **Transfer of Purchasing Power and Clearing Function:** The basic function of the foreign exchange market is to facilitate the conversion of one currency into another i.e. payment between exporters and importers. For eg. Indian rupee is converted into U.S. dollar and vice-versa. In performing the transfer function variety of credit instruments are used such as telegraphic transfers, bank drafts and foreign bills. Telegraphic transfer is the quickest method of transferring the purchasing power.
2. **Credit Function:** The foreign exchange market also provides credit to both national and international, to promote foreign trade. It is necessary as sometimes, the international payments get delayed for 60 days or 90 days. Obviously, when foreign bills of exchange are used in international payments, a credit for about 3 months, till their maturity, is required.
3. **Hedging Function:** A third function of foreign exchange market is to hedge foreign exchange risks. By hedging, we mean covering of a foreign exchange risk arising out of the changes in exchange rates. Under this function the foreign exchange market tries to protect the interest of the persons dealing in the market from any unforeseen changes in exchange rate. The exchange rates under free market can go up and down; this can either bring gains or losses to concerned parties. Hedging guards the interest of both exporters as well as importers, against any changes in exchange rate. Hedging can be done either by means of a spot exchange market or a forward exchange market involving a forward contract.

Participants and dealers in foreign exchange market

Foreign exchange market needs dealers to facilitate foreign exchange transactions. Bulks of foreign exchange transaction are dealt by Commercial banks & financial institutions. RBI has also allowed private authorized dealers to deal with foreign exchange transactions i.e buying & selling foreign

currency. The main participants in foreign exchange markets are

1. **Retail Clients:** Retail Clients deal through commercial banks and authorised agents. They comprise people, international investors, multinational corporations and others who need foreign exchange.
2. **Commercial Banks:** Commercial banks carry out buy and sell orders from their retail clients and of their own account. They deal with other commercial banks and also through foreign exchange brokers.
3. **Foreign Exchange Brokers:** Each foreign exchange market centre has some authorised brokers. Brokers act as intermediaries between buyers and sellers, mainly banks. Commercial banks prefer brokers.
4. Central Banks: Under floating exchange rate central bank does not interfere in exchange market. Since 1973, most of the central banks intervened to buy and sell their currencies to influence the rate at which currencies are traded.

Types of foreign exchange market

Foreign Exchange Market is of two types retail and wholesale market.

1. **Retail Market:** The retail market is a secondary price maker. Here travellers, tourists and people who are in need of foreign exchange for permitted small transactions, exchange one currency for another.
2. **Wholesale Market:** The wholesale market is also called interbank market. The size of transactions in this market is very large. Dealers are highly professionals and are primary price makers. The main participants are Commercial banks, Business corporations and Central banks. Multinational banks are mainly responsible for determining exchange rate.
3. **Other Participants**

   a) Brokers: Brokers have more information and better knowledge of market. They provide information to banks about the prices at which there are buyers and sellers of a pair of currencies. They act as middlemen between the price makers.

   b) Price Takers: Price takers are those who buy foreign exchange which they require and sell what they earn at the price determined by primary price makers.

Foreign exchange market India

The FX market plays significant role in the global trade in determining the strength of an economy and its growth. World have moved into transition of foreign exchange practices after Bretton Woods in 1944, fixed to flexible exchange rate regime in 1972. During this period India has been

following the global practices moving from peg exchange rate regime to floating rate exchange system and currently following market. based exchange system. Even though, the Indian exchange rate is being controlled by Reserve Bank of India (RBI). Global FX market comprises of the spot market, the forward market, the future market, and the options in the derivatives market segment. In India during August 2008 first foreign currency trading system was introduced against US dollar, then Euro, British Pound Sterling and Japanese Yen in the National Stock Exchange of India (NSE), later in the Multi-Commodity Exchange of India for currency trading (MCX-SX), and Bombay Stock Exchange of India (BSE). Now exclusive exchange started by BSE in the name of United Stock Exchange of India (USE).

The foreign exchange market India is growing very rapidly. The annual turnover of the market is more than $400 billion. This transaction does not include the inter-bank transactions. The Indian foreign exchange market consists of the buyers, sellers, market intermediaries and the monetary authority of India**.** The main center of foreign exchange transactions in India is Mumbai, the commercial capital of the country. There are several other centers for foreign exchange transactions in the country including Kolkata, New Delhi, Chennai, Bangalore, Pondicherry and Cochin. In past, due to lack of communication facilities all these markets were not linked. But with the development of technologies, all the foreign exchange markets of India are working collectively. One important steps taken related to India's forex exchange system was - rupees was made *convertible in current account*. This leads paved to the path of foreign exchange payments/receipts to be converted at market-determined exchange rate. Convertibility in current account means that individuals and companies have the freedom to buy or sell foreign currency on specific activities like foreign travel, medical expenses, college fees, as well as for payment/receipt related to export-import, interest payment/receipt, investment in foreign securities, business expenses etc. An related concept to this is the "convertibility in capital account". Convertibility in capital account indicates that Indian people and business houses can freely convert rupee to any other currency to any extent and can invest in foreign assets like shares, real estate in foreign countries. Most importantly Indian banks can accept deposit in any currency.

The role of Foreign exchange market

The foreign exchange (forex) market is the world's biggest financial market by far. According to the Bank for International Settlements' (BIS) triennial survey, global forex turnover in April 2010 averaged a staggering $4.0 trillion daily, an increase of 20% from $3.3 trillion three years earlier. In

an increasingly globalized economy, the significance of the foreign exchange marketplace to the average consumer cannot be underestimated. The rate at which our domestic currency can be exchanged in the global forex market determines the price we pay for an increasing number of products, the price tag for our vacations, the rate of return on our investments (ROI) and even the interest rate on our loans and deposits.

Transactions in the foreign exchange market can be broadly classified into two types – commercial and speculative. A commercial transaction is one that is backed by an underlying economic activity, such as payment for an import or a loan to an overseas entity. A speculative transaction, on the other hand, is one undertaken purely to make a profit from currency moves. Speculative transactions greatly exceed commercial transactions in the realm of foreign exchange, and they have accounted for a greater share of forex trading volumes over the years. Also, currency trading volume in the 1970s was only about six times the value of global trade in goods and services. But by 1995, daily forex trading volume of $1.2 trillion was approximately 50 times this value.

Forex trading volume has increased more than threefold since then, driven largely by speculation. A study based on the 2010 BIS survey found that the ratio of forex turnover to gross domestic product (GDP) – a good measure of speculative activity – ranged from about 14 for the United States and Japan to 200 for the United Kingdom and more than 300 for Singapore. Also, despite the 20% increase in daily forex volumes between 2007 and 2010, commercial transactions by corporations and governments actually declined by 10% over this period. Commercial transactions accounted for only 13% of daily total forex volume in 2010, the lowest share since 2001.Online forex trading by retail investors has grown enormously since 2007, with such transactions contributing to about $125 billion to $150 billion in daily forex turnover. The lure of making money by speculating on exchange rate movements is obviously a powerful one.

Pitfalls in Foreign Exchange market

For a retail forex trader, the biggest risk of non-regulation is that of illegal activity or outright fraud.. Following are the limitation of foreign exchange market

1. **Heightened Volatility**: The surge in speculative activity, especially high-frequency trading dominated by computerized or algorithmic trading, may contribute to higher currency volatility, which increases the risk of runaway losses for the small investor or trader.
2. **Information Disadvantage:** Retail investors are at a distinct disadvantage in the largely unregulated global forex market, since they do not have access to information about large

commercial transactions and capital flows only available to the biggest players who dominate the market. This information unevenness makes it difficult for the average retail investor to gain any type of advantage over professionals.

3. **Higher Hedging Costs**: Increased currency volatility caused by excessive speculation leads to higher costs incurred by corporations and other commercial players for hedging currency risk.
4. **Systemic Importance of Big Banks:** While forex trading losses were not prominent in the biggest trading losses posted by corporations and financial institutions to date, the potential does exist for billion-dollar losses on wrong currency bets. Although currency trading is a zero-sum game, a massive loss incurred by a big bank could have a ripple effect on the global economy due to its systemic importance.
5. **Undue Enrichment of a Few at the Expense of Millions:** Exaggerated or unjustified currency moves can adversely affect a nation's economy. Although such moves may be justified by underlying economic fundamentals in some cases, in many other cases temporary weakness in a currency can be exploited ruthlessly by speculators, sending it into freefall in a self-fulfilling prophecy. This can trigger capital flight and a prolonged recession precipitated by sharply higher interest rates to defend the currency. This scenario has played out on several occasions over the past two decades; a notable instance being the collapse of the Thai baht in July 1997 and the subsequent Asian crisis. While currency speculators raked in the profits, millions of people in the affected nations suffered huge wealth erosion and long periods of unemployment.

Conclusion

Liberalization has transformed India's external sector and a direct beneficiary of this has been the foreign exchange market in India. From a foreign exchange-starved, control-ridden economy, India has moved on to a position of $150 billion plus in international reserves with a confident rupee and drastically reduced foreign exchange control. As foreign trade and cross-border capital flows continue to grow, and the country moves towards capital account convertibility, the foreign exchange market is poised to play an even greater role in the economy, but is unlikely to be completely free of RBI interventions any time soon.

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