

Balance of Payments

- The balance of payments is the record of all international trade and financial transactions made by a country's residents.
- The balance of payments has three components—the current account, the financial account, and the capital account. Current accounts measure international trade, net income on investments, and direct payments. The financial account describes the change in international ownership of assets. The capital account includes any other financial transactions that don't affect the nation's economic output.

- **Trade Account:**

- This includes the trade of visible or tangible items.
- It is also referred to as Visible trade or Merchandise trade

- **Current Account**

- The current account is used to monitor the inflow and outflow of goods and services between countries.
- This account covers all the receipts and payments made with respect to raw materials and manufactured goods.
- It also includes receipts from engineering, tourism, transportation, business services, stocks, and royalties from patents and copyrights. When all the goods and services are combined, together they make up to a country's Balance Of Trade (BOT).
- There are various categories of trade and transfers which happen across countries.
- It could be visible or invisible trading, unilateral transfers or other payments/receipts.
- Trading in goods between countries are referred to as visible items and import/export of services (banking, information technology etc.) are referred to as invisible items.
- Unilateral transfers refer to money sent as gifts or donations to residents of foreign countries. This can also be personal transfers like – money sent by relatives to their family located in another country.

- A surplus on this account is welcome but a deficit needs to be controlled especially for poor economies.
- Beyond a certain limit, this deficit becomes a difficult situation as it has to be filled with the inflows in capital account, extra borrowings or drawing from foreign exchange reserves.

- **Capital Account**

- The Capital account includes all the short-term and long-term transactions between a country and the world.
- Usually, these types of flows of money are related to saving and investment, but speculation has turned into a major component of the account in recent times.
- In the capital account, both direct and portfolio foreign investment is recorded. External assistance and commercial borrowing are presented net repayment.
- Direct investment identifies the money which moves across national boundaries with the intention of investing in a business.
- Portfolio investment moves across national boundaries with the intention of purchasing shares and bonds.
- The Official reserves means the reserves of gold and foreign exchange kept by the Reserve Bank of India to be used by the government.

4. Errors and Omission

- According to double entry book – keeping concept for every credit, there exists a matching debit and thus, there must be a balance in BOP as well. In reality BOP may not balance. Once various types of international financial flows are recorded, the statistical discrepancy, referred to as errors and omissions, is also recorded. The statistical discrepancy occurs due to complications associated with collecting balance of payments data.

- **Overall Balance:**
- It is obtained by adding up current account and capital account balances. If current account is negative and capital account is positive, the overall balance will be negative or positive depending upon the size of each balance.

Receipts (Credits)	Payments (Debits)
1) Exports of goods	1) Imports of goods
Trade Account Balance	
2) Exports of services	2) Imports of services
3) Interest, profits and dividends received	3) Interest, profits and dividends paid
4) Unilateral receipts	4) Unilateral payments
5)	Current Account Balance (1 to 4)
6) Foreign investments	6) Investments abroad
7) Short term borrowing	7) Short term lending
8) Medium and long term borrowing	8) Medium and long term lending
9)	Statistical discrepancy (Errors and omissions)
10)	Capital Account Balance (6 to 9)
11)	Overall Balance = Current Account + Capital Account Balance (5 + 10)
12) Change in reserves (-)*	12) Change in reserves (+)*
Total Receipts = Total Payments	

Foreign Exchange Reserves

- These are reserves held in the form of foreign currencies like pound, dollar, gold or special drawing rights.
- When a country has surplus in both current account and capital account, foreign exchange reserves go up, and vice versa.
- If the deficit in current account exceeds inflows in capital account, foreign exchange reserves from the reserve account is used to meet the deficit.
- If a country's surplus is transferred to Foreign Exchange Reserves, the transaction is shown as minus in that country's BoP account.
- A (-) minus sign shows an increase in forex, whereas (+) plus sign shows a fall in forex due transfer of funds to cover a deficit in BoP.

- **Official Settlement:**

The surplus or deficit in BoP is adjusted by transferring funds to or from forex, which is called as official settlement.

- BoP is always at balance in accounting sense. The balance in the balance of payments implies that a net credit in any one of the items must have a counter part net debit in another.
- A balance in BoP is achieved when overall balance is zero, i.e. current account deficit or surplus is matched by a surplus or deficit in capital account.
- The BoP Balances when all the items in BoP are taken and the deficit or surplus in BoP is corrected by accommodating items.
- Thus, in a technical sense BoP is always at balance.

Autonomous and Accommodating Capital Flows

- **Autonomous Flows:** They take place in the ordinary course of foreign trade and they are independent of other items in BoP.
- **Accommodative Flows** take place only because other items in BoP are such, as to have a gap of this size to be filled. It may be in the form of loans or gifts from a foreign country.
- A surplus is a result of autonomous receipts being greater than autonomous payments.
- Deficit in BoP arises when autonomous payments are more than autonomous receipts.

Autonomous receipts $>$ Autonomous Payments = Surplus

Autonomous receipts $<$ Autonomous Payments = Deficit

Types of Disequilibrium

1. Short run: Prevailing for a year or few years. Such disequilibrium occurs due to sudden increase in demand for foreign goods and services. Such disturbances do not require major policy decisions. They can be corrected through short-run decisions.
2. Long-run Disequilibrium: It is caused by continuous excess demand for foreign exchange. The main cause for a fundamental disequilibrium can be found in –
 - i. Excess imports for planned economic development
 - ii. Continuous increase in population
 - iii. Domestic investment exceeding domestic savings
 - iv. Increase in the price of imports
 - v. Decline in the demand for exports

3. Cyclical Disequilibrium: Interdependent countries are subject to transmission of international economic ups and downs.

4. Structural Disequilibrium: It arises due to structural changes in the supply of factors of production.

Corrective Measure to Control Deficit in BoP

- a. Devaluation: It aims at influencing the prices of only traded goods and not the general price level. Devaluation refers to an official announcement by the monetary authority through which the exchange rate is changed, i.e. value of domestic currency is reduced as against foreign currency. Deficit in BoP is expected to be corrected due to increased exports and reduced imports.
- b. Depreciation: This, like devaluation, lowers the value of domestic currency or increase the value of foreign currency. Depreciation takes place in a free, competitive market due to market forces.

However, success of these measures depends upon elasticity of demand of foreign goods.

- According to Marshall-Lerner Condition, devaluation will improve BoP if -

- $N_x + N_m > 1$

N_x = price elasticity of demand for exports of devaluing country

N_m = price elasticity of demand for imports in devaluing country

- Further, cooperation of trade partner countries is equally necessary. If the exporting trade partners go for competitive devaluation, it will cancel out the effect of devaluation on the BoP of the country that devaluated first.

c. Deflation: This refers to the process of decline in general price level. This leads to people increasing domestic consumption of goods and reduction imports.

D. Direct Controls:

- i. Tariff
- ii. Quotas
- iii. Export Exemptions
- iv. Import Substitution: tax concessions, technical assistance, subsidies, provision of scarce inputs to encourage domestic production

FOREIGN EXCHANGE RATES

- The rate at which the currencies of two nations are exchanged for each other is called the rate of exchange. For example, if 1 U.S. dollar is exchanged for Rs. 10 then foreign exchange rate is 1 U.S. \$ = Rs. 10.
- In other words, the rate of exchange is nothing but the value or price of a country's currency expressed in terms of a foreign currency.
- Exchange rate is in equilibrium when there is no excess supply of or demand for it in the foreign exchange market, and therefore there is no tendency for the exchange rate to change.

1. Spot and Forward Exchange Rates:

- Spot rate of exchange is the current exchange rate between the two currencies.
- Its is determined by the market forces i.e. demand for and supply of foreign exchange
- It is the rate at which immediate delivery of foreign exchange has to be made.
- E.g The demand for dollar is derived from the country's demand for imports which are paid in dollar and supply of dollar is derived from the country's exports which are sold in terms of dollars.

- Spot date refers to the delivery date of the currency. As per the international standards, the delivery of the currency takes place on the second day from the date of settlement.
- **Forward rate of exchange:** When forward exchange is determined in the foreign exchange market, the purchase and sale of foreign exchange is agreed upon at a fixed future date.
- These contracts usually have maturity of 30, 60 and 90 days.
- This rate is determined close to the spot exchange rate.
- It can be expressed in terms of the amount of local currency at which a dealer will buy and sell a unit of foreign currency. This is termed as outright rate.
- The forward rate can also be quoted in terms of points called the forward points. If the foreign currency is traded in premium rate, the forward points are added to the spot rate, whereas points are subtracted from the spot rate if the currency is traded at discount.

- The link between spot and forward rates come from three activities:
- Arbitrage, hedging and speculation.
- **Arbitrage** is the strategy of taking advantage of price differences in different markets for the same asset. For it to take place, there must be a situation of at least two equivalent assets with differing prices.
- In essence, arbitrage is a situation where a trader can profit from the imbalance of asset prices in different markets. The simplest form of arbitrage is purchasing an asset in the market where the price is lower and simultaneously selling the asset in the market where the asset's price is higher.
- Forex arbitrage states that it is basically a very low-risk method, where traders exploit the pricing inefficiencies in the market, by buying and selling several currency pairs simultaneously.

- Because the Forex markets are decentralized, even in this era of automated algorithmic trading, there can exist moments where a currency traded in one place is somehow being quoted differently from the same currency in another trading location. An arbitrageur able to spot the discrepancy can buy the lower of the two prices and sell the higher of the two prices and likely lock in a profit on the divergence.
- Automated algorithmic trading has shortened the timeframe for forex arbitrage trades. Price discrepancies that could last several seconds or even minutes now may remain for only a sub-second timeframe before reaching equilibrium.
- Two Point Arbitrage: Where two countries are involved
- Triangular or three point arbitrage: Where three countries are involved

- Relation between rate of interest and arbitrage:
- If real rate of inflation differs in countries, the exchange rate will also differ and arbitrage will be possible.

- **Hedging** refers to operation to protect against risk arising out of exchange rate changes.
- The strategy of hedging involves increasing hard currency which is likely to appreciate and decreasing soft currency which is likely to depreciate and at the same time decreasing hard currency liabilities and increasing soft currency liabilities.
- For example, if depreciation of Indian rupee is expected, the basic hedging strategy would be - reduce the level of cash rupees, increase local currency borrowing, delay accounts payable and sell weak currency forwards, speed up all the payments to be done in hard currency and delay all the receivable from abroad.

- **Speculation** is the purchase or sale of an asset in the expectation of a gain from changes in the price of that asset or change in exchange rate.
- Speculators participate in the forward exchange market by entering into forward exchange deal.
- They do so on the basis of their own calculations of the difference between the forward rate and the spot rate that may prevail on a future date.
- Speculators are in the market to earn profit. But their activities may lead to destabilization of foreign exchange market.

- Stabilizing speculation refers to the purchase of a foreign currency when the domestic price of a foreign currency falls with the expectation of its increase and off earning profit. It also refers to sale of foreign exchange when its price increases with the expectation that it would soon fall.
- Destabilizing speculation refers to the purchase of a foreign currency when the exchange rate falls.

Fixed Exchange Rate System

- A fixed exchange rate is a regime applied by a government or central bank that ties the country's official currency exchange rate to another country's currency or the price of gold. The purpose of a fixed exchange rate system is to keep a currency's value within a narrow band.
- **Bretton Woods Gold Exchange Standard:**
- From the end of World War II to the early 1970s, the Bretton Woods Agreement meant that the exchange rates of participating nations were pegged to the value of the U.S. dollar, which was fixed to the price of gold. Accordingly, \$35 = 1 ounce of gold was promised by USA.
- When the United States' post-war balance of payments surplus turned to a deficit in the 1950s and 1960s, the periodic exchange rate adjustments permitted under the agreement ultimately proved insufficient.
- In 1973, President Richard Nixon removed the United States from the gold standard, ushering in the era of floating rates.

- **Gold Standard:** It operated from around 1880 to the beginning of WW I in 1914.
- It was a monetary system in which the standard unit of currency is a fixed quantity of gold or is kept at the value of a fixed quantity of gold. The currency is freely convertible at home or abroad into a fixed amount of gold per unit of currency.
- The reign of the full gold standard was short, lasting only from the 1870s to the outbreak of World War I.
- That war saw recourse to inconvertible paper money or to restrictions on gold export in nearly every country. By 1928, however, the gold standard had been virtually reestablished, although, because of the relative scarcity of gold, most nations adopted a gold-exchange standard, in which they supplemented their central-bank gold reserves with currencies (U.S. dollars and British pounds) that were convertible into gold at a stable rate of exchange.
- The gold-exchange standard collapsed again during the Great Depression of the 1930s, however, and by 1937 not a single country remained on the full gold standard.

Arguments for Fixed Exchange Rates

- **(i) Promotion of International Trade:**
- If the exchange rates are fixed or stable, the prices of internationally traded goods become more stable and predictable. Under this system, the exporters know in advance what they will receive in terms of the domestic currency and importers know how much they will have to pay. Given such a certainty, which does not exist in a freely fluctuating exchange system, the international trade can definitely expand.
- **(ii) International Division of Labour and Specialisation:**
- The system of fixed exchange rate not only promotes international trade but also contributes in raising productivity and absolute output through increased international division of labour and specialisation.

- **(iii) Promotion of Economic Integration:**

- In an economic union, member countries strive to evolve a common currency. That is the necessary requirement for integrating their economic policies. The system of fixed exchange rate is just like a common currency in which the exchange value of the currency remains unchanged in terms of the domestic currency of a particular country.

- **(iv) Long-Term Capital Investments:**

- In case of stable exchange rates there is little uncertainty and risk. As a consequence, the investors can plan long-term international investments. Large scale capital inflows from abroad can facilitate the achievement of a higher rate of growth. The greater uncertainty and risk under the flexible exchange system, in contrast, is likely to impede the long-term capital flows.

- **(v) No Adverse Effect of Speculation:**
- Since the exchange rate remains stable under the fixed exchange system, there is little scope for speculation and the consequent adverse effects. The advocates of fixed exchange system point out that the speculation is destabilising under the flexible exchange system. The speculation is said to be destabilising, if speculators purchase a foreign currency when exchange rate is rising, and sell it when exchange rate is falling in the expectation that the exchange rate will change even more in the same direction.

- **(vi) Confidence in the Strength of Currency:**
- This exchange system does not involve appreciation or depreciation of currency. There is no fear of risk of loss due to larger holding of foreign currency, if the value of currency declines. This imparts greater confidence in the strength of the domestic currency.
- **(vii) Suited to Currency Areas:**
- The system of fixed exchange rates is more suited to countries included in such regional arrangements as dollar area or sterling area or Euro-area. A fixed rate of exchange between dollar and sterling with other currencies is likely to have very positive effect on trade, BOP adjustments, capital flows and growth. The flexible exchange system in these currency areas is likely to lead to chaotic conditions and create serious problems in payment adjustments.

- **Growth of Money and Capital Markets:**

- The system of stable exchange rate stimulates the growth of money and capital markets through facilitating rapid expansion of trade and international capital flows. When there existed stable exchange rates under gold standard, smooth flow of international lending continued and that brought about steady expansion in international money markets.

- **Beneficial for Trade-Dependent Countries:**

- Certain countries like England, France, Japan and Belgium have excessive dependence on foreign trade. The contribution of external trade in the gross national product in their case is quite high. The recurring fluctuation in the rates of exchange can create serious dislocations in trade and domestic production. Thus the whole economic system is likely to be in jeopardy. It is imperative that trade-dependent countries should have more stable exchange rates.

Arguments against Fixed Exchange Rates

- **(i) Primacy to Exchange Stability:**
- A serious defect in this system of exchange rates is that the authorities become concerned primarily with the maintenance of exchange rate at some official level. It often results in the sacrifice of the objectives of price stability and full employment. In a country under fixed exchange system, the BOP deficit can be corrected through deflationary policies that may result in a fall in prices, recession and greater unemployment.
- Similarly the correction of BOP surplus will require inflationary policies. Thus the society has to bear a much heavier cost for maintaining stable exchange rates. In contrast, the flexible exchange system makes BOP adjustments through exchange variations and there is no need to sacrifice internal stability.

- **(ii) International Transmission of Economic Variations:**

- The fixed or stable exchange rates can be responsible for transmitting the economic disturbances in one country to another. Suppose there are deflationary conditions in one country. It will export its low-price goods to other countries. The industries of foreign countries, faced with competition from cheap goods, will be forced to lower their prices.
- Thus deflationary conditions get transmitted. Similarly the inflationary trends in one country will get transmitted to the other countries. In this way, the economic variations, under the fixed exchange system, leak out from one country to its trading partners and vice-versa.

- **(iii) Need to Build Exchange Reserves:**
- The necessity of maintaining the exchange rate at an official level makes the authorities to undertake pegging operations. For this purpose, it is necessary to maintain sufficient reserves of foreign currencies. Unless these reserves are maintained, a country faced with BOP deficit will have to depend upon devaluation. The holding of large reserves of foreign currencies in the idle form is clearly costly, uneconomical and wasteful. Under the flexible exchange system, there is no uneconomic build-up of international liquid reserves.

- **(iv) Heavy Burden upon the Authorities:**
- If a country is under continuous pressure on account of the BOP deficit, the government or monetary authority may not be in a position to mobilise sufficient international liquid resources for undertaking the pegging operations. In the event of failure to mobilise reserves of foreign currencies, the home currency has to be devalued.
- Sometimes this step might have to be adopted repeatedly within a short span. Such a situation will seriously undermine the strength of the home currency and the accompanying loss of confidence in it.

- **(v) Difficulty in Building Up of Exchange Reserves:**
- Under a fixed exchange system, every country is required to build up idle stock of foreign currencies. It necessitates the BOP surplus at least for some years. The LDCs will find it difficult to have BOP surpluses for building up sufficient foreign exchange reserves. It is often beyond their capacity to even offset the persistent BOP deficit.
- **(vi) Possibility of Speculation:**
- It is generally believed that in a system of fixed exchange rate, there is little scope for speculation in foreign exchange. In this connection, it must be recognised that speculation, undoubtedly, will not occur in respect of variations in exchange rates but the speculators can still make anticipations about the timing and extent of possible devaluation or about the timing and scale of pegging operations.

- **(vii) Exchange Controls:**

- The policy of fixed or stable exchange rates requires quite complicated exchange control mechanism. This can result in misallocation of economic resources, bureaucratic inefficiency and corruption.

- **(viii) No Solution of BOP Problem:**

- The policy of fixed exchange rates cannot help in resolving the problem of BOP deficit. It simply suppresses it through the government intervention. The forces underlying the BOP disequilibrium remain to be tackled through monetary, fiscal and other policies. Under this system, the entire attention is paid to the stabilization of exchange rate rather than dealing with the BOP disequilibrium. The stabilisation of exchange rate itself becomes the end and no longer remains a means to adjust the BOP disequilibrium.

- **(ix) Suited only of Short Period:**

- The policy of fixed exchange rates cannot be pursued as a long-term policy. As technological and structural changes take place, the official rate of exchange may be rendered unrealistic. The BOP difficulties and fluctuations in international commodity prices can force the different countries to revise the exchange rates.

Flexible Exchange Rate

- A floating exchange rate is a regime where the currency price of a nation is set by the forex market based on supply and demand relative to other currencies. This is in contrast to a fixed exchange rate, in which the government entirely or predominantly determines the rate.

- **Clean Float:** Clean float, also called free float or pure currency exchange rate, is a floating exchange rate system wherein a currency's value relies heavily on a country's law of supply and demand. In spite of a government's non-interference, rates are determined, and often it is done by acknowledging any market force that can weaken or strengthen an economy. It is coined with the term "clean" due to its disassociation with different outside entities such as countries' central banks and other financial institutions. Typically, it is a result of capitalism and free market economics.

- **Dirty Float:** Here the government intervenes deliberately to influence the exchange rate, especially to depreciate the currency, to increase exports and solve BoP problems.
- **Crawling Peg:** This system allows the par values to change by small pre-announced amounts or percentages at frequent and specified intervals of one or two months till the equilibrium rate is reached.
- **Free float V/s Managed Float:** The countries having flexible exchange rate system either have a free float in the market or retained certain control over it in order to manage the exchange rate as per the national interest.

Advantages of Flexible Exchange Rate

- **(i) Automatic Adjustment in BOP:**
- The chief merit of the freely fluctuating exchange rate is that the BOP disequilibrium gets corrected automatically with the change in exchange rate.
- If a BOP deficit arises, there would be an excess supply of home currency leading to a fall in exchange rate simply by the market forces of demand and supply. This causes export goods cheaper and import goods dearer.

- **(ii) No Collusion Between Internal-External Objectives:**
- Surplus and deficit in the BOP accounts get corrected if foreign exchange rate falls and rises, respectively. In a regime of fixed exchange rate, the removal of BOP deficit requires the adoption of internal policies like fall income and price level. In other words, pegged exchange rate requires a change in domestic macroeconomic policies like deflationary policies of price and output reduction.
- But, under flexible exchange rate system, a government can adopt independent monetary policy. In other words, under this system of exchange rate, internal balance could be maintained by the government. It is further argued that, as it is a self-adjusting mechanism to restore BOP equilibrium, a government can put more effort in tackling internal problems of inflation, unemployment, etc.

- **(iii) Absorption of Sudden Shocks:**
- In a flexible exchange rate, the domestic economy remains insulated from external shocks and pressures. Under this system, the threat of 'importing inflation' from outside the country is minimum. In other words, price feedback effect is imperceptible.
- **(iv) Minimum Buffer of Foreign Exchange Reserves:**
- Since exchange rate is not pegged under the floating arrangement of exchange rate, the central bank of a country need not hold adequate foreign exchange reserves as a buffer against unforeseen developments in international trade.

Disadvantages of Flexible Exchange Rate

- **(i) Uncertainty and Confusion:**
- Flexible exchange rate and trade presents an atmosphere of uncertainty and confusion in trade and investment. Susceptibility to uncertainty is greater as soon as exchange rate fluctuates freely. Suppose an Indian has despatched an export 'invoice' to the foreign buyers. But the Indian exporters do not know at what price foreign currency will be converted into Indian currency.
- This kind of uncertainty hampers trade. However, such uncertainty can be largely minimised through forward exchange contracts. The uncertainty involved in this kind of exchange rate may cause trading community to lose some confidence in the system.

- **(ii) Hampering Investment:**
- Unregulated free- floating exchange rate often discourages foreign investment as exchange rate becomes erratic and, hence, destabilising. Because of the uncertainty associated with this exchange rate involving profit and loss implications of foreign investment deals, a country might experience decumulation of capital. Hence—it is destabilising in effect.
- **(iii) Risk, Instability, and Speculation:**
- Flexible exchange rate encourages wide speculation since foreign exchange prices are not known in advance as in fixed exchange rate. It is because of speculation there occurs disruptive hot money flows. To put it elaborately, it can be argued that when the exchange rate tends to decline, speculators anticipate that such would continue to decline further and the possibility of the flight of money to another country will brighten. This will then cause a further fall in the exchange rate. Thus, greater the speculation against a currency, the deeper the economic crises.

(iv) Inflationary in Character:

- By nature, flexible exchange rate is inflationary. As soon as the exchange rate falls, automatically, consequent upon the BOP deficit, import goods become expensive. High cost of imported goods then fuels inflationary tendencies. As depreciation of a currency makes import costlier, the domestic economy faces both demand-pull and cost-push inflationary pressures.
- It is because of these drawbacks of the freely fluctuating exchange rate that countries attach importance to 'managed exchange rate' with their central banks buying and selling currencies in the foreign exchange market so as to moderate the degree of fluctuations as far as practicable.

Managed Float and Its Objectives

- A managed floating exchange rate is an exchange rate system that allows a nation's central bank to intervene regularly in foreign exchange markets to change the direction of the currency's float and/or reduce the amount of currency volatility. This exchange rate system is also known as a "dirty float".
- Managed float regimes are where exchange rates fluctuate, but central banks attempt to influence the exchange rates by buying and selling currencies.
- **Central bank might attempt to bring about a depreciation to:**
 - Improve the balance of trade or improve the current account by making exports more price competitive
 - Reduce the risk of a deflationary recession - a lower currency increases export demand and increases the domestic price level by making imports more expensive
 - Rebalance the economy away from consumption towards higher exports and capital investment
- **Or to bring about an appreciation of the currency:**
 - To curb demand-pull inflationary pressures
 - To reduce the prices of imported capital and technology or essential inputs to enhance long run growth potential

Features of Foreign Exchange Market

- **High Liquidity**
- The foreign exchange market is the most liquid financial market in the world. It involves the trading of various currencies across the globe. All traders in this market are free to buy or sell currencies anytime as per their choice. They are free to exchange currencies without prices of currencies being traded getting affected. Currencies prices remain the same both at the time of order placed and executed thereby enabling to earn the expected prices.
- **Market Transparency**
- Trader in the foreign exchange market has full access to all market data and information. They can easily monitor different countries' currencies price fluctuations through real-time portfolio and account tracking without the need of a broker. All this information helps in making better trading decisions and control over investments.

- **Dynamic Market**
- The foreign exchange market is a dynamic market. In these markets, currency values change every second and hour. These values changes in accordance with changing forces of demand and supply which also helps in determining the exchange rates. Due to its fast-changing character, this market is termed as the perfect market to trade.
- **Operates 24 Hours**
- Foreign exchange markets function 24 hours a day. It provides a platform where currencies can be traded anytime by traders. It provides a convenient time to all necessary adjustments when and wherever needed.

- **Lower Trading Cost**

- The forex market has a very low trading cost. In these markets, there are no commissions like in case of any other investments. Any difference between buying and selling prices of currencies is the only cost of trading in the forex market. As there are low costs then the possibility of incurring losses is also minimum thereby making it possible for small investors to make good profit from trading.

- **Dollar Most Widely Traded**

- The dollar is the most dominant currency in the foreign exchange market. This currency is paired with every country's currency being traded in the forex market. In a major proportion of transactions every day, the dollar is one of the two currencies being traded.

Functions of the foreign exchange market

- **1. Transfer Function:**

- The basic function of the foreign exchange market is to facilitate the conversion of one currency into another, i.e., to accomplish transfers of purchasing power between two countries. This transfer of purchasing power is effected through a variety of credit instruments, such as telegraphic transfers, bank draft and foreign bills.
- In performing the transfer function, the foreign exchange market carries out payments internationally by clearing debts in both directions simultaneously, analogous to domestic clearings.

- **2. 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 3 months, till their maturity, is required.

- **3. Hedging Function:**

- A third function of the foreign exchange market is to hedge foreign exchange risks. Hedging means the avoidance of a foreign exchange risk. In a free exchange market when exchange rate, i. e., the price of one currency in terms of another currency, change, 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 amounts of net claims or net liabilities which are to be met in foreign money.

- Exchange risk 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 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 transaction takes place 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.

Participants in Foreign Exchange Market

- Participants in Foreign exchange market can be categorized into five major groups, viz.; commercial banks, Foreign exchange brokers, Central bank, MNCs and Individuals and Small businesses.
- **1. Commercial Banks:**
- The major participants in the foreign exchange market are the large Commercial banks who provide the core of market. As many as 100 to 200 banks across the globe actively participate in the foreign exchange. These banks serve their retail clients, the bank customers, in conducting foreign commerce or making international investment in financial assets that require foreign exchange.

- **2. Foreign Exchange Brokers:**

- Foreign exchange brokers also operate in the international currency market. They act as agents who facilitate trading between dealers. Unlike the banks, brokers serve merely as matchmakers and do not put their own money at risk.
- They actively and constantly monitor exchange rates offered by the major international banks through computerized systems such as Reuters and are able to find quickly an opposite party for a client without revealing the identity of either party until a transaction has been agreed upon. This is why inter-bank traders use a broker primarily to disseminate as quickly as possible a currency quote to many other dealers.

- **3. Central banks:**

- Another important player in the foreign market is Central bank of the various countries. Central banks frequently intervene in the market to maintain the exchange rates of their currencies within a desired range and to smooth fluctuations within that range. The level of the bank's intervention will depend upon the exchange rate regime followed by the given country's Central bank.

- **4. MNCs:**

- MNCs are the major non-bank participants in the forward market as they exchange cash flows associated with their multinational operations. MNCs often contract to either pay or receive fixed amounts in foreign currencies at future dates, so they are exposed to foreign currency risk. This is why they often hedge these future cash flows through the inter-bank forward exchange market.

- **5. Individuals and Small Businesses:**

- Individuals and small businesses also use foreign exchange market to facilitate execution of commercial or investment transactions. The foreign needs of these players are usually small and account for only a fraction of all foreign exchange transactions. Even then they are very important participants in the market. Some of these participants use the market to hedge foreign exchange risk.

Factors Influencing Exchange Rate

- **1. Inflation**

- If inflation in the India is relatively lower than elsewhere, then India's exports will become more competitive, and there will be an increase in demand for Rupee to buy Indian goods. Also, foreign goods will be less competitive and so Indian citizens will buy fewer imports.
- Therefore countries with lower inflation rates tend to see an appreciation in the value of their currency.

2. Interest Rate

- If India's interest rates rise relative to elsewhere, it will become more attractive to deposit money in India. Investors will get a better rate of return from saving in Indian banks. Therefore demand for Rupee will rise. This is known as "hot money flows" and is an important short-run factor in determining the value of a currency.
- Higher interest rates cause an appreciation.
- Cutting interest rates tends to cause a depreciation

3. Speculation

- If speculators believe the rupee will rise in the future, they will demand more now to be able to make a profit. This increase in demand will cause the value to rise. Therefore movements in the exchange rate do not always reflect economic fundamentals but are often driven by the sentiments of the financial markets. For example, if markets see news which makes an interest rate increase more likely, the value of the pound will probably rise in anticipation.

- **4. Change in competitiveness**

- If Indian goods become more attractive and competitive this will also cause the value of the exchange rate to rise. For example, if the India has long-term improvements in labour market relations and higher productivity, good will become more internationally competitive and in long-run cause an appreciation in the Rupee. This is a similar factor to low inflation.

- **5. Relative strength of other currencies**

- In 2010 and 2011, the value of the Japanese Yen and Swiss Franc rose because markets were worried about all the other major economies – US and EU. Therefore, despite low-interest rates and low growth in Japan, the Yen kept appreciating. In the mid-1980s, the Pound fell to a low against the Dollar – this was mostly due to the strength of Dollar, caused by rising interest rates in the US.

- **6. Balance of payments**

- A deficit on the current account means that the value of imports (of goods and services) is greater than the value of exports. If this is financed by a surplus on the financial/capital account, then this is acceptable. But a country which struggles to attract enough capital inflows to finance a current account deficit will see a depreciation in the currency.

- **7. Government debt**

- Under some circumstances, the value of government debt can influence the exchange rate. If markets fear a government may default on its debt, then investors will sell their bonds causing a fall in the value of the exchange rate. For example, Iceland debt problems in 2008, caused a rapid fall in the value of the Icelandic currency.
- For example, if markets feared the US would default on its debt, foreign investors would sell their holdings of US bonds. This would cause a fall in the value of the dollar

- **8. Government intervention**

- Some governments attempt to influence the value of their currency. For example, China has sought to keep its currency undervalued to make Chinese exports more competitive. They can do this by buying US dollar assets which increases the value of the US dollar to Chinese Yuan.

- **9. Economic growth/recession**

- A recession may cause a depreciation in the exchange rate because during a recession interest rates usually fall. However, there is no hard and fast rule. It depends on several factors

• TYPES OF EXCHANGE RATE QUOTATIONS

• Direct Quotation

- **Meaning:** Under this method, the quote is expressed in terms of domestic currency. This means that the rate expresses how one unit of domestic currency relates to the foreign currency. This method is also alternatively referred to as the price quotation method.
- Therefore, if the value of the domestic currency increases, a smaller amount of it would have to be exchanged. Conversely a decline in value would create a situation where a large amount of the domestic currency would have to be exchanged. Hence, it can be said that the quotation rate has an inverse relationship with the value of the domestic currency.
- The value of the domestic currency is assumed to be 1 in case of a direct quotation. The price being quoted explains the number of units of foreign currency that can be exchanged for a single unit of domestic currency.

- **Example:** An example of a direct quote using U.S. dollars might be stating \$1.17 Canadian per U.S. dollar.
- **Usage:** The direct quote method is one of the most widely used quotation methods across the world. This is the norm for quoting Forex prices and is assumed de facto until another method has been explicitly mentioned.

- **Indirect Quotation**

- **Meaning:** This method is the opposite of the direct quotation method. Under this method, the quote is expressed in terms of foreign currency. Therefore this rate assumes one unit of foreign currency. It then expresses how many units of domestic currency are required to obtain a single unit of a foreign currency. Sometimes this quote is also expressed in terms of 100 units of foreign currency. This method is often referred to as the quantity quotation method.
- Since this method is quoted in terms of foreign currency, the quoted rate has a direct correlation with the domestic rate. If the quote goes up, so does the value of the domestic currency and vice versa.
- **Example:** 85.5 U.S. cents per Canadian dollar