



globalsyn infotech

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Forex Market

White Paper

An Introduction to Forex Market

Foreign Exchange

"Foreign Exchange" is buying of one currency and selling of another. Currencies are traded in pairs, for example Euro/US Dollar (EUR/USD) or US Dollar/Japanese Yen (USD/JPY).

The foreign exchange market exists as a result of international trade and capital transactions between countries, and facilitates those transactions by converting one currency into another.

Business activities that may give rise to the need for foreign exchange transactions include:

-  Exporting
-  Importing
-  Foreign currency borrowings
-  Foreign currency investments
-  Profit and interest repatriation
-  Other payments and receivables in foreign currencies

In the foreign exchange market, the currency trader's goal is to earn as much profit as possible as a result of purchasing and selling foreign currencies.

Currency exchange rates fluctuate perpetually based on continuous supply and demand by traders in addition to other more significant factors

Consider a transaction case as mentioned in the table below:

Transaction	Buyer	Buy	Sell	Deal Rate	Buy Amount	Sell Amount	Local Currency Amount(INR)	Wash Rate
Buy	Akshay	USD	INR	45.50 INR	USD 10000	INR 4,55,000	4,55,000.00	45.50
Sell	Samrat	INR	USD	INR 45.75	INR 1,14,3750	25000 USD	INR 1,14,3750	45.75
Buy	IDBI Bank	USD	INR	INR 45.60	USD 50,000	INR 2,28,000	2,28,000.00	45.60
Sell	Vikram	INR	Euro	INR 54.60	INR 13,65,000	Euro 25,000.00	13,65,000.00	54.60
Buy	Union Bank	Euro	USD	USD 1.2	Euro 25000	Euro 30,000.00	13,65,000.00	54.60

Note that the column is with respect to HDFC bank...

Case 1 : Akshay approaches HDFC bank to sell \$10000, since he has received \$10000 from his customer by export. The rate offered by HDFC bank is 45.50 INR. The bank has to pay 4, 55,000 INR to Akshay and it will receive \$10000 in its Nostro account. Thus, in the 3rd and 4th column, we have mentioned USD and INR respectively. The first column indicates a but transaction as HDFC is buying USD currency from Akshay This transaction reflects an overbought transaction as the bank is in excess of 10000\$ from the zero position i.e. the square position.

Case 2 : Samrat wants to buy \$25,000 from the bank. However, the bank is having only 10000\$ and it cannot afford to lose the customer and it commits to Samrat at a deal rate of 45.75 INR. The bank cannot wait for another customer to get USD. To meet up with the commitment, HDFC bank will approach other bank or financial institutions where the foreign currency is available at a profitable rate.

Case 3 : As related to case 2, the bank has finally committed with IDBI bank at a deal rate of 45.60 INR as mention in case 3 However, IDBI bank agrees to sell a minimum of \$50000. This can be reflected in the row 3 as shown in the table. This is a typical scenario of an inter bank transaction

Case 4 : Vikram has a requirement to pay 25000 Euro to his importer. He approaches the bank for the same. HDFC bank offers him deal rate of 54.60 INR. This transaction can be reflected in the row 4 of the table above

Case 5 : With the requirement of 25000 Euros, HDFC bank again approaches other bank or financial institutions where the foreign currency is available at a profitable rate with the currency pair of EURO-USD. Such a transaction is called as Crosscurrency transaction. Finally, it commits to Union Bank to buy 25,000 euros. Since the USD, INR and EURO rate are available in the market, we have arrived at deal rate of 1.2 \$/EURO.

What is the need for LCY amount and Wash rate?

Although the transaction involved foreign currencies, the bank has to keep track of the money inflow and outflow in its own currency to keep a track of the current position and to satisfy the rules and regulations that have been by the Reserve bank of India(in the case of India). For this reason, a new column has been introduced in the table which is called the Local currency column. In the absence of this column, it would have become mandatory to track the INR inflow and outflow by checking the respective columns in the table. Thus, the tedious procedure of tracking can be avoided. Wash rate is the same as deal rate expressed in INR. It is required to calculate the local currency amount.

Reading a foreign exchange quote may seem a bit confusing at first. However, it's really quite simple if you remember two things: 1) The first currency listed first is the base currency and 2) the value of the base currency is always 1.

The US dollar is the centerpiece of the Forex market and is normally considered the base' currency for quotes. In the "Majors", this includes USD/JPY, USD/CHF and USD/CAD. For these currencies and many others, quotes are expressed as a unit of \$1 USD per the second currency quoted in the pair. For example, a quote of USD/JPY 110.01 means that one U.S. dollar is equal to 110.01 Japanese yen. When the U.S. dollar is the base unit and a currency quote goes up, it means the dollar has appreciated in value and the other currency has weakened. If the USD/JPY quote we previously mentioned increases to 113.01, the dollar is stronger because it will now buy more yen than before.

The three exceptions to this rule are the British pound (GBP), the Australian dollar (AUD) and the Euro (EUR). In these cases, you might see a quote such as GBP/USD 1.7366, meaning that one British pound equals 1.7366 U.S. dollars. In these three currency pairs, where the U.S. dollar is not the base rate, a rising quote means a weakening dollar, as it now takes more U.S. dollars to equal one pound, euro or Australian dollar.

In other words, if a currency quote goes higher, that increases the value of the base currency. A lower quote means the base currency is weakening.

Currency pairs that do not involve the U.S. dollar are called cross currencies, but the premise is the same. For example, a quote of EUR/JPY 127.95 signifies that one Euro is equal to 127.95 Japanese yen.

When trading forex you will often see a two-sided quote, consisting of a 'bid' and 'ask': The 'bid' is the price at which you can sell the base currency (at the same time buying the counter currency). The 'ask' is the price at which you can buy the base currency (at the same time selling the counter currency).

To illustrate a typical FX trade, consider the following example :

The current bid/ask price for EUR/USD is 1.2320/23, meaning you can buy 1 euro with 1.2323 US dollars or sell 1 euro for 1.2320 US dollars.

Suppose you decide that the Euro is undervalued against the US dollar. To execute this strategy, you would buy Euros (simultaneously selling dollars), and then wait for the exchange rate to rise.



So you make the trade: to buy 100,000 euros you pay 123,230 dollars ($100,000 \times 1.2323$). Remember, at 1% margin, your initial margin deposit would be \$1,232 for this trade.

As you expected, Euro strengthens to 1.2395/98. Now, to realize your profits, you sell 100,000 euros at the current rate of 1.2395, and receive \$123,950.

You bought 100k Euros at 1.2323, paying \$123,230. You sold 100k Euros at 1.2395, receiving \$123,950. That's a difference of 72 pips, or in dollar terms ($\$123,950 - \$123,230 = \$720$).

Total profit = US \$720

The market can be split between the 'spot' market and the 'forward' market :

Spot Transaction :

A spot transaction provides for the purchase or sale of one currency against another, where the exchange rate is agreed today for physical delivery in two business days. It is possible for a foreign exchange transaction to take place for settlement prior to the spot date. Settlement on the same day is known as value 'tod' or value today. Settlement on the next business day is known as value 'tom' or value tomorrow.

Forward Transaction :

Forward transaction of Foreign Exchange refers to the transaction of foreign exchange settled on the agreed date and as per the agreed exchange rate after the finalization of business by both parties. A forward transaction of foreign exchange can last one year the longest. A transaction in excess of one year is called a super-forward transaction of foreign exchange. Forward Transaction of Foreign Exchange is a commonly-used method to avoid foreign exchange risks and to fix foreign change cost. Generally speaking, for customer settlements in foreign trade, making investment abroad, foreign exchange loans or paying back the loans all involve maintenance of value of foreign exchanges. By doing forward transactions of foreign exchange, the customer can fix in advance the foreign exchange cost for an item, or hold up the costs in terms of foreign exchange for the forward transaction of foreign exchange so as to achieve the goal of maintaining the value and can further enable the enterprise to focus the time and human resources on its own operation.

Terms used in Forex :

Authorized Dealer : A financial institution or bank authorized to deal in foreign exchange

Cross Currency Transaction : A foreign exchange deal entered into involving two currencies, neither of which is the base currency.

Delivery date : The date of maturity of the contract, when the exchange of the currencies is made. This date is more commonly known as the value date in the FX or Money markets

Exchange control : Rules used to preserve or protect the value of a countries currency

Fixed exchange rate : Official rate set by monetary authorities. Often the fixed exchange rate permits fluctuation within a band.

Foreign Exchange : The purchase or sale of a currency against sale or purchase of another.

Forex : Term commonly used when referring to the foreign exchange market.

Inter-bank rates : The bid and offer rates at which international banks place deposits with each other. The basis of interbank market are :

Overnight limit : Net long or short position in one or more currencies that a dealer can carry over into the next dealing day. Passing the book to other bank dealing rooms in the next trading time zone reduces the need for dealers to maintain these unmonitored exposures.

Overnight : A deal from today until the next business day

Risk management : The identification and acceptance or offsetting of the risks threatening the profitability or existence of an organization. With respect to foreign exchange involves among others consideration of market, sovereign, country, transfer, delivery, credit, and counter party risk.

Risk Position : An asset or liability, which is exposed to fluctuations in value through changes in exchange rates or interest rates.

Rollover : An overnight swap, specifically the next business day against the following business day (also called Tomorrow Next, abbreviated to Tom-Next).

Same day transaction : A transaction that matures on the day the transaction takes place.

Selling rate : Rate at which a bank is willing to sell foreign currency.

Settlement date : The date upon which foreign exchange contracts settle.

Swap transaction : The simultaneous purchase and sale of the same amount of a given currency for two different dates, against the sale and purchase of another. A swap can be a swap against a forward. In essence, swapping is somewhat similar to borrowing one currency and lending another for the same period. However, any rate of return or cost of funds is expressed in the price differential between the two sides of the transaction

Value Date : For a spot transaction it is two business banking days forward in the country of the bank providing quotations which determine the spot value date. The only exception to this general rule is the spot day in the quoting center coinciding with a banking holiday in the country(ies) of the foreign currency(ies). The value date then moves forward a day.

Vostro Account : A local currency account maintained with a bank by another bank. The term is normally applied to the counter party's account from which funds may be paid into or withdrawn, as a result of a transaction

Net Position : The amount of currency bought or sold which have not yet been offset by opposite transactions

Gap : A mismatch between maturities and cash flows in a bank or individual dealers position book. Gap exposure is effectively interest rate exposure.

Front Office : The activities carried out by the dealer, normal trading activities

Nostro : A bank account that one bank holds with another bank in a foreign country. This account is usually held in the foreign country's currency, and is used to carry out transactions that are denominated in that foreign currency.

Wash rate : Wash rate is the deal rate through INR. It is used to calculate the local currency amount

FCNR deposits : FCNR stands for foreign currency non resident deposits. It is an interest bearing account. Deposits can be opened for any period from 12 months to maximum of 36 months in any of the three designated currencies viz. Pound Sterling, US Dollar and EURO.

Deposits can be made by remittances from abroad or by funds held in existing NRE accounts.

Accounts can be opened jointly with other Non-Resident Indians.

No Exchange loss as interest and principal amounts are payable in the same currency in which it is deposited.

Interest is compounded every half yearly.

Loan Facility is available.

Nomination facility is available

Interest earned on these accounts is free from income tax.

Funds invested in NRE and FCNR accounts by Non-Residents are free from Wealth