NSB | Business School
ACADEMY

EDITION 40

FOREIGN EXCHANGE MARKET

11/10/2021

ABSOLUTE FINANCE

FOREIGN EXCHANGE MARKET

The foreign exchange market is over a counter (OTC) global marketplace that determines the exchange rate for currencies around the world. This foreign exchange market is also known as Forex, FX, or even the currency market. The participants engaged in this market are able to buy, sell, exchange, and speculate on the currencies.

These foreign exchange markets are consisting of banks, forex dealers, commercial companies, central banks, investment management firms, hedge funds, retail forex dealers, and investors.

The forex market is not dominated by a single market exchange, but a global network of computers and brokers from around the world. Forex brokers act as market makers as well and may post bid and ask prices for a currency pair that differs from the most competitive bid in the market.

The forex market is made up of two levels—the interbank market and the over-the-counter (OTC) market. The interbank market is where large banks trade currencies for purposes such as hedging, balance sheet adjustments, and on behalf of clients. The OTC market, on the other hand, is where individuals trade through online platforms and brokers.

$6.6 trillion

The number of daily forex transactions registered in April 2019, according to the 2019 Triennial Central Bank Survey of FX and OTC derivatives markets.

HISTORY

Up until World War I, currencies were pegged to precious metals, such as gold and silver. Then, after the Second World War, the system collapsed and was replaced by the Bretton Woods agreement. That agreement resulted in the creation of three international organizations to facilitate economic activity across the globe. They were the following:

1. International Monetary Fund (IMF)
2. General Agreement on Tariffs and Trade (GATT)
3. International Bank for Reconstruction and Development (IBRD)

The new system also replaced gold with the U.S. dollar as a peg for international currencies. The U.S. government promised to back up dollar supplies with equivalent gold reserves. But the Bretton Woods system became redundant in 1971 when U.S. President Richard Nixon announced a "temporary" suspension of the dollar's convertibility into gold.

Did you know that the GBP/USD currency pair is known as the Cable in the forex market? Amused? The reason why the pair is called the Cable is that before the advent of satellites and fibre optics, the London and New York Stock Exchanges were connected via a giant steel cable that ran under the Atlantic.

SIZE OF FOREX MARKET

1. According to BIS's 2019 triennial survey, trading in FX markets reached an incredible $6.6 trillion per day in April of 2019.

2. The worth of the entire global forex trading market is estimated to approximately $2.4 quadrillion – in other words, around $2409 trillion.1

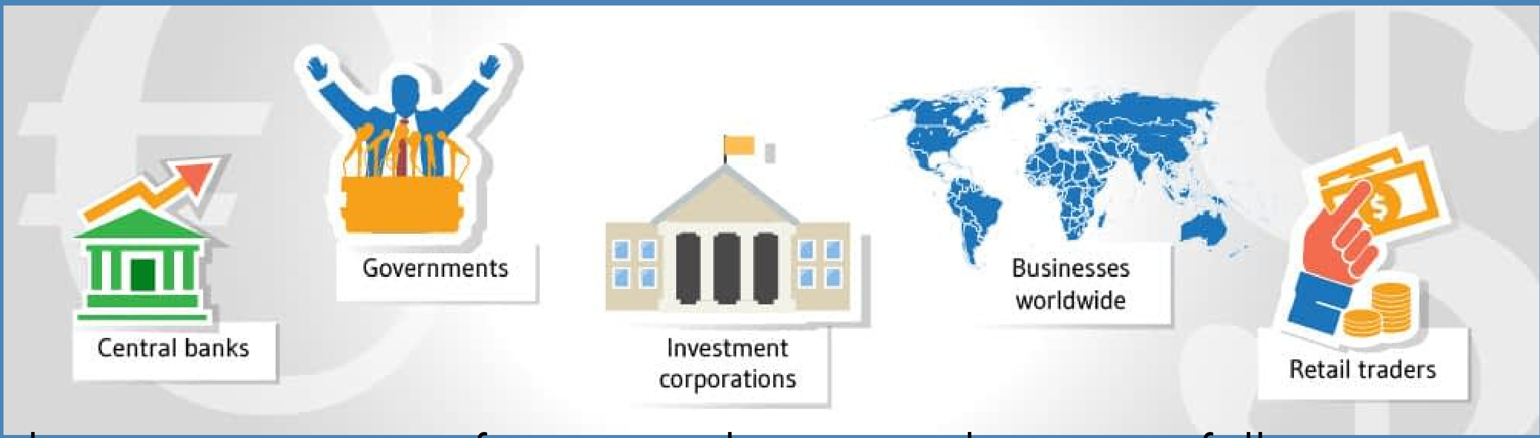
3. Global GDP in 2019 amounted to roughly 142 trillion dollars – meaning that the annual turnover of the forex market is almost 17 times larger.2

4. The forex market dwarfs even the largest stock exchanges in the world – for example, Nasdaq has a daily volume that averages around $200 billion.

5. Over 170 currencies are traded on the global forex market.

spot forex- $2 trillion
Forwards -$1 trillion
Foreign Exchange Swaps- $3.2 trillion
Currency Swaps- $108 billion
Options and others $294 billion

PARTICIPANTS OF FOREX MARKET



The participants in a foreign exchange market are as follows:

Central Bank: The central bank takes care of the exchange rate of the currency of their respective country to ensure that the fluctuations happen within the desired limit and this participant keeps control over the money supply in the market.

Commercial Banks: Commercial banks are the channel of forex transactions, which facilitates international trade and exchange to its customers. The commercial banks also provide foreign investments.

Traditional Users: The traditional users consist of foreign tourists, the companies who carry out business operations across the globe.

Traders and Speculators: The traders and the speculators are the opportunity seekers who look forward to making a profit through trading on short-term market trends.

Brokers: Brokers are considered to be the financial experts who act as a sure intermediary between the dealers and the investors by providing the best quotations.

FACTS

- **London is the largest forex hub in the world, followed by New York and then Singapore**
- **Deutsche Bank is the world's largest foreign exchange dealer with over 21% in market share**

TYPES OF FOREIGN EXCHANGE MARKET

Spot Market : In this market, the quickest transaction of currency occurs. This foreign exchange market provides immediate payment to the buyers and the sellers as per the current exchange rate. The spot market accounts for almost one-third of all the currency exchange, and trades which usually take one or two days to settle the transactions.

Forward Market: In the forward market, there are two parties which can be either two companies, two individuals, or government nodal agencies. In this type of market, there is an agreement to do a trade at some future date, at a defined price and quantity.

Future Markets: The future markets come with solutions to a number of problems that are being encountered in the forward markets. Future markets work on similar lines and basic philosophy as the forward markets.

Option Market: An option is a contract that allows (but is not as such required) an investor to buy or sell an instrument that is underlying like a security, ETF, or even index at a determined price over a definite period of time. Buying and selling 'options' are done in this type of market.

Swap Market: A swap is a type of derivative contract through which two parties exchange the cash flows or the liabilities from two different financial instruments. Most swaps involve these cash flows based on a principal amount.

Advantages and Disadvantages of Forex Trading

Pros

Lots of flexibility, trading almost 24/7

Plenty of trading options

Low transaction costs

Cons

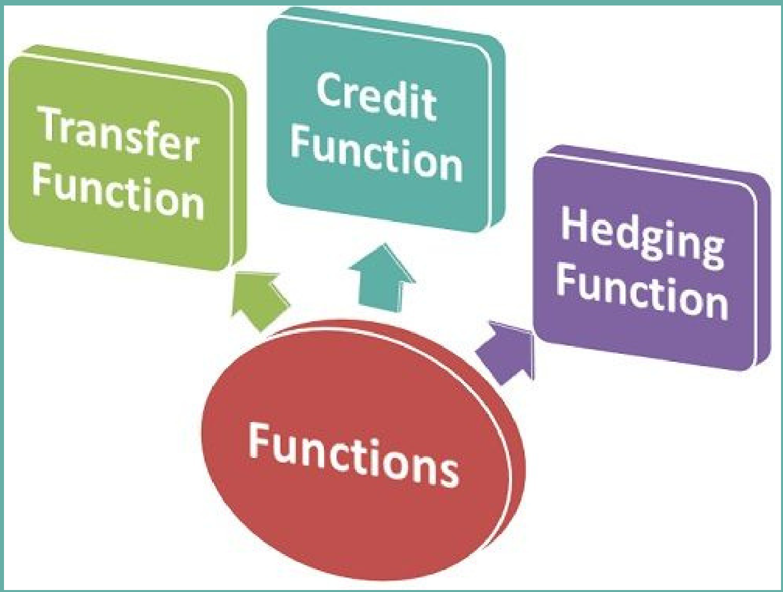
Lack of regulation increases counterparty risk

High leverage amounts allowed

Operational risk

Functions of Foreign Exchange Market

TRANSFER FUNCTION: The basic and the most obvious function of the foreign exchange market is to transfer the funds or the foreign currencies from one country to another for settling their payments. The market basically converts one's currency to another.



CREDIT FUNCTION: The FOREX provides short-term credit to the importers in order to facilitate the smooth flow of goods and services from various countries. The importer can use his own credit to finance foreign purchases.

HEDGING FUNCTION: The third function of a foreign exchange market is to hedge the foreign exchange risks. The parties in the foreign exchange are often afraid of the fluctuations in the exchange rates, which means the price of one currency in terms of another currency. This might result in a gain or loss to the party concerned.

Features of Foreign Exchange Market

High Liquidity: The foreign exchange market is the most easily liquefiable financial market in the whole world. This involves the trading of various currencies worldwide. The traders in this market are free to buy or sell the currencies anytime as per their own choice.

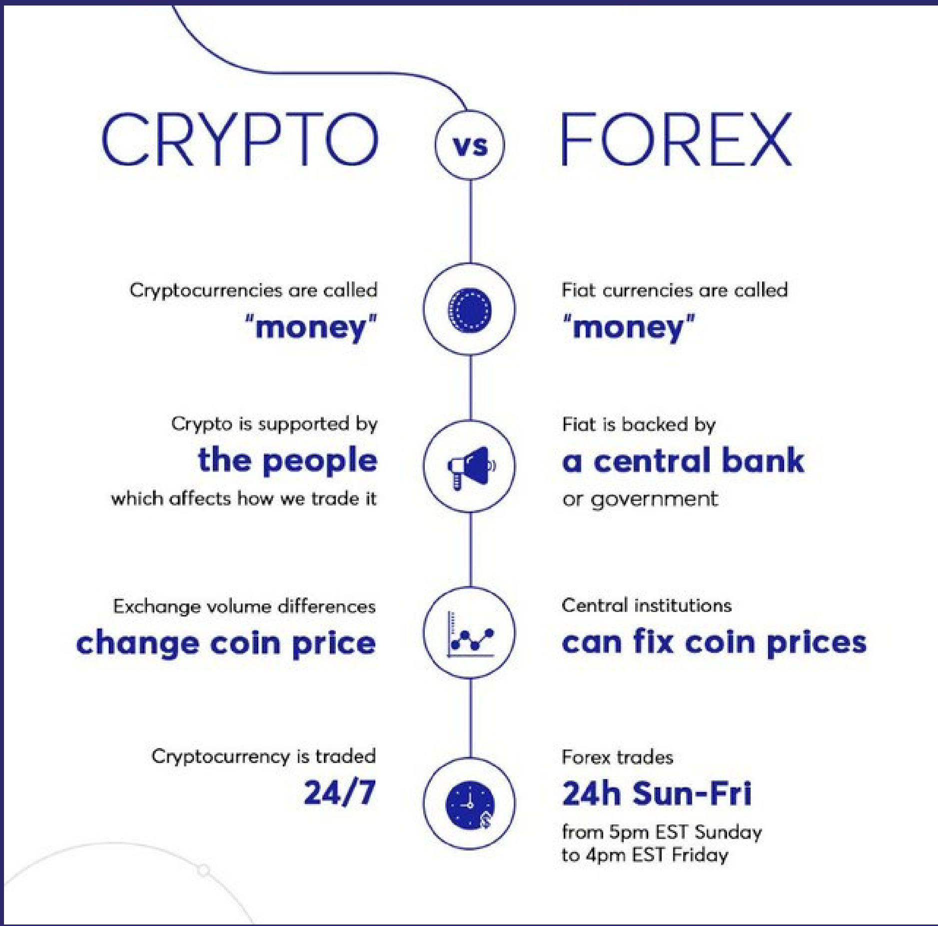
Market Transparency: There is much clarity in this market. The traders in the foreign exchange market have full access to all market data and information. This will help to monitor different countries' currency price fluctuations through the real-time portfolio.

Dynamic Market: The foreign exchange market is a dynamic market structure. In these markets, the currency values change every second and hour.

Operates 24 Hours: The Foreign exchange markets function 24 hours a day. This provides the traders the possibility to trade at any time.

CRYPTO VS FOREX

The key is to approach the cryptocurrency exchange market understanding that while it bears many of the same traits of forex, it is a currency exchange in its own right.



"Arbitrage„ in Foreign Exchange Market

Arbitrage is the process of a simultaneous sale and purchase of currencies in two or more foreign exchange markets with an objective to make profits by capitalizing on the exchange-rate differentials in various markets.

The arbitrage opportunities exist due to the inefficiencies of the market. Thus, the price differential is captured as a trade's net payoff. This payoff should be large enough to cover the expenses incurred in executing the trade.

"Speculation„ in Foreign Exchange Market

"Speculation" in Foreign Exchange is an act of buying and selling the foreign currency under the conditions of uncertainty with a view to earning huge gains.

The speculation is said to have both the stabilizing and destabilizing impact on the exchange rate.

The advocates of flexible exchange rate believe that the speculation cannot be destabilizing. It is said, that the speculator buys the currency when it is weak and sells when it is strong, then it will be stabilizing.

Trading forex vs stocks vs indices. Which one is better?

Stocks:

- It requires a higher amount of capital to trade due to the low leverage.
- The percentage of returns is low also due to the low leverage.
- Commissions may be high.
- They have the best volatility, which means more accurate signals and trends.

Forex:

- It requires a lower amount of capital to trade due to the high leverage.
- The percentage of returns is potentially bigger although it may be dangerous if you take unnecessary risks.
- Usually, it has no commissions.
- The volatility could be better most of the time, which means less accurate signals and trends.

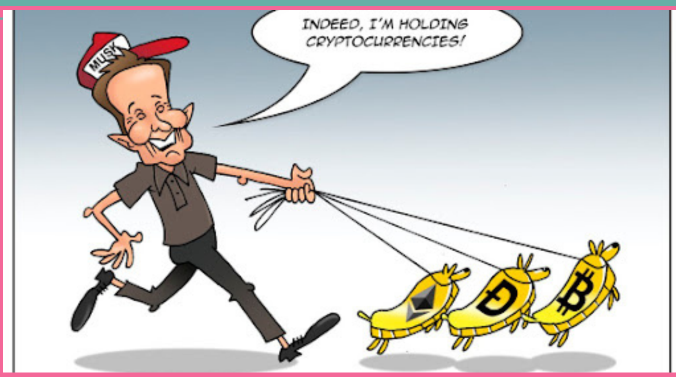
Indices:

- They are somewhere in the middle between forex and stocks.
- The leverage is not giant like forex but it's enough to trade without a big amount of capital.
- They have good volatility and they deliver good signals and trends.
- On the con side, the amount of choices is small. You have a lot of forex pairs and stocks to choose to trade. On indices, you only have a small amount. If they are slow during some particular days without presenting good opportunities, you may not have an alternative index to trade. You need to wait for the next day.

FACT

More than 85% of the global forex market transactions happens on only 7 currency pairs known as the majors (EURUSD, USDJPY, GBPUSD, AUDUSD, NZDUSD, USDCAD, USDCHF)

STOCKS FOREX INDICES CRYPTO ???????



WHICH ONE ARE YOU GOING TO HOLD??

https://www.instagram.com/nsbindia/

https://twitter.com/nsbindia/

https://www.nsb.edu.in/

https://www.youtube.com/c/NSBAcademy

https://www.facebook.com/nsbindi

https://in.linkedin.com/school/nsbindia/