# Chapter 12 Understanding of Foreign Exchange Rates.

## Introduction

An exporter without any commercial contract is completely exposed of foreign exchange risks that arises due to the probability of an adverse change in exchange rates. Therefore, it becomes important for the exporter to gain some knowledge about the foreign exchange rates, quoting of exchange rates and various factors determining the exchange rates. In this section, we have discussed various topics related to foreign exchange rates in detail.

## Spot Exchange Rate

Also known as "benchmark rates", "straightforward rates" or "outright rates", spot rates represent the price that a buyer expects to pay for a foreign currency in another currency. Settlement in case of spot rate is normally done within one or two working days.

## Forward Exchange Rate

The forward exchange rate refers to an exchange rate that is quoted and traded today but for delivery and payment on a specific future date.

## Method of Quoting Exchange Rates

There are two methods of quoting exchange rates:

- Direct Quotation: In this system, variable units of home currency equivalent to a fixed unit of foreign currency are quoted.
  For example: US $ 1= Rs. 42.75

- Indirect Quotation: In this system, variable units of foreign currency as equivalent to a fixed unit of home currency are quoted.
  For example: US $ 2.392= Rs. 100

Before 1993, banks were required to quote all the rates on indirect basis as foreign currency equivalent to RS. 100 but after 1993 banks are quoting rates on direct basis only.

## Exchange Rate Regime

The exchange rate regime is a method through which a country manages its currency in respect to foreign currencies and the foreign exchange market.

- Fixed Exchange Rate
  A fixed exchange rate is a type of exchange rate regime in which a currency's value is matched to the value of another single currency or any another measure of value, such as gold. A fixed

exchange rate is also known as pegged exchange rate. A currency that uses a fixed exchange rate is known as a fixed currency. The opposite of a fixed exchange rate is a floating exchange rate.

- Floating Exchange Rate
  A Floating Exchange Rate is a type of exchange rate regime wherein a currency's value is allowed to fluctuate according to the foreign exchange market. A currency that uses a floating exchange rate is known as a floating currency. A Floating Exchange Rate or a flexible exchange rate and is opposite to the fixed exchange rate.
- Linked Exchange Rate
  A linked exchange rate system is used to equlise the exchange rate of a currency to another. Linked Exchange Rate system is implemented in Hong Kong to stabilise the exchange rate between the Hong Kong dollar (HKD) and the United States dollar (USD).
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## Forward Exchange Contracts

A Forward Exchange Contract is a contract between two parties (the Bank and the customer). One party contract to sell and the other party contracts to buy, one currency for another, at an agreed future date, at a rate of exchange which is fixed at the time the contract is entered into.

## Benefits of Forward Exchange Contract

- Contracts can be arranged to either buy or sell a foreign currency against your domestic currency, or against another foreign currency.
- Available in all major currencies.
- Available for any purpose such as trade, investment or other current commitments.
- Forward exchange contracts must be completed by the customer. A customer requiring more flexibility may wish to consider Foreign Currency Options.

## Foreign Currency Options

Foreign Currency Options is a hedging tool that gives the owner the right to buy or sell the indicated amount of foreign currency at a specified price before a specific date. Like forward contracts, foreign currency options also eliminate the spot market risk for future transactions. A currency option is no different from a stock option except that the underlying asset is foreign exchange. The basic premises remain the same: the buyer of option has the right but no obligation to enter into a contract with the seller. Therefore the buyer of a currency option has the right, to his advantage, to enter into the specified contract.

## Flexible Forwards

Flexible Forward is a part of foreign exchange that has been developed as an alternative to forward exchange contracts and currency options. The agreement for flexible forwards is always singed between two parties (the ‘buyer’ of the flexible forward and the 'seller' of the flexible forward) to exchange a specified amount (the ‘face value’) of one currency for another currency at a foreign exchange rate that is determined in accordance with the mechanisms set out in the agreement at an agreed time and an agreed date (the ‘expiry time’ on the ‘expiry date’). The exchange then takes place approximately two clear business days later on the ‘delivery date’).

# Currency Swap

A currency swap which is also known as cross currency swap is a foreign exchange agreement between two countries to exchange a given amount of one currency for another and, after a specified period of time, to give back the original amounts swapped.

# Foreign Exchange Markets

The foreign exchange markets are usually highly liquid as the world's main international banks provide a market around-the-clock. The Bank for International Settlements reported that global foreign exchange market turnover daily averages in April was $650 billion in 1998 (at constant exchange rates) and increased to $1.9 trillion in 2004 [1]. Trade in global currency markets has soared over the past three years and is now worth more than $3.2 trillion a day. The biggest foreign exchange trading centre is London, followed by New York and Tokyo.