Foreign Exchange Market: Meaning, Functions and Kinds

Meaning:

Foreign exchange market is the market in which foreign currencies are bought and sold. The buyers and sellers include individuals, firms, foreign exchange brokers, commercial banks and the central bank.

Like any other market, foreign exchange market is a system, not a place. The transactions in this market are not confined to only one or few foreign currencies. In fact, there are a large number of foreign currencies which are traded, converted and exchanged in the foreign exchange market.

Functions of Foreign Exchange Market:

Foreign exchange market performs the following three functions:

1. Transfer Function:

It transfers purchasing power between the countries involved in the transaction. This function is performed through credit instruments like bills of foreign exchange, bank drafts and telephonic transfers.

2. Credit Function:

It provides credit for foreign trade. Bills of exchange, with maturity period of three months, are generally used for international payments. Credit is required for this period in order to enable the importer to take possession of goods, sell them and obtain money to pay off the bill.

3. Hedging Function:

When exporters and importers enter into an agreement to sell and buy goods on some future date at the current prices and exchange rate, it is called hedging. The purpose of hedging is to avoid losses that might be caused due to exchange rate variations in the future.

Kinds of Foreign Exchange Markets:

Foreign exchange markets are classified on the basis of whether the foreign exchange transactions are spot or forward accordingly, there are two kinds of foreign exchange markets:

(i) Spot Market,

(ii) Forward Market.

(i) Spot Market:

Spot market refers to the market in which the receipts and payments are made immediately. Generally, a time of two business days is permitted to settle the transaction. Spot market is of daily nature and deals only in spot transactions of foreign exchange (not in future transactions). The rate of exchange, which prevails in the spot market, is termed as spot exchange rate or current rate of exchange.

The term 'spot transaction' is a bit misleading. In fact, spot transaction should mean a transaction, which is carried out 'on the spot' (i.e., immediately). However, a two day margin is allowed as it takes two days for payments made through cheques to be cleared.

(ii) Forward Market:

Forward market refers to the market in which sale and purchase of foreign currency is settled on a specified future date at a rate agreed upon today. The exchange rate quoted in forward transactions is known as the forward exchange rate. Generally, most of the international transactions are signed on one date and completed on a later date. Forward exchange rate becomes useful for both the parties involved in the transaction.