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Foreign Exchange Market

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1 Foreign Exchange Market

The foreign exchange market (FOREX market) refers to a global market which is entitled to define the foreign exchange rates between currencies of diverse countries (Lee & Sabbaghi, 2019). The FOREX market entails activities of purchasing, selling, as well as converting currencies at the prevailing rates. According to Engel (2019), FOREX comes out as the leading financial market globally. The FOREX trading is self-regulated because participants must both compete as well as cooperate. According to Lee and Sabbaghi (2019), there is no uptick rule in the FOREX market as it is the case with stock exchange markets. There are no specified limits on the size of a trader's position. The central banks occupies a quite essential part in the FOREX markets. As such, central banks regulates the flow of money, rates of inflation, in addition to the interest rates. The national central bank offers both official and unofficial target rates their currencies. Nations central banks are entitled to apply their substantial FOREX markets reserves to make the currency market stable. This paper addresses the role of the foreign markets, FOREX rates quotation among other concerns.

The Functions of the Foreign Exchange Markets

The roles of the FOREX markets in every sovereign economy can never be overlooked. The foreign exchange market helps in making transfers (Lee & Sabbaghi, 2019). As evident, the most fundamental role of the FOREX markets is to accurately transfer purchasing power amid nations. Herein, the FOREX markets are entitled to enhance currency conversion, an activity which is undertaken via the credit instruments. These includes bank drafts, telephonic transfers and foreign bills of exchange (Engel, 2019). In this important role, the FOREX markets is entitled to carry out payments globally via payment of debts through guidelines concurrently, like it is the case with domestic clearings.

Another role of the FOREX market is offering credit across nations, with an aim to promote trade. Through the FOREX markets, importers stand the opportunity to obtain credit to finance their external purchases (Zhang et al., 2019). The importer essentially acquires the IOU, which locks in the currency exchange rate while allowing the importer to dispose imported products for 90 days before the note is payable.

FOREX markets helps in hedging foreign exchange risks, a role which comes out as a way of getting rid of a foreign exchange risk. In an open market situation, when exchange rates fluctuate, the concerned parties may either make a profit or incur a loss (Engel, 2019). The concerned parties in this regard may undertake inevitable exchange risks if there exists a larger number of liabilities which need to be accomplished via foreign currency (Sato, 2019). The FOREX market is therefore entitled to take control of the exchange by either reducing or avoiding the affiliated risks. Menkhoff and Stöhr, (2017) assert that the FOREX market offers the necessary tools for hedging the anticipated as well as actual claims via forwarding conventions (contracts) in exchange rates. Forward contract period lasts for three months, and no transactions are carried out within this period, and the parties are required to actively ignore any likely changes in exchange rates.

The foreign exchange market is suitably featured with varied primary institutions and organizations, and each plays a pivotal duty in the FOREX markets. The leading participants in the forex market include FOREX brokers, commercial banks, multinational corporations, investors, and small businesses as well. Considerably, commercial banks take a critical role in the FOREX market by providing the core of the market (Menkhoff & Stöhr, 2017). With over 200 commercial banks globally, they substantially make as well as define the forex market by acting as merchandizing clients (Menkhoff & Stöhr, 2017). Commercial banks operate in two

great levels, and these include retail levels and wholesale level. With regard to retail level, commercial stores aim at meeting the exchange needs of customer organizations and exporters. In the wholesale level, commercial stores are aimed at maintaining an inert bank market in FOREX markets.

Another crucial component is FOREX brokers who also operate in the global currency market. Johnson (2020) assert that these brokers act as trusted mediators who accurately expedite trading amid dealers. They serve as matchmakers, and they rarely or do not put their funds at risk at all. More importantly, FOREX brokers take the initiative to observe exchange rates existing via the most trusted commercial stores via computer systems, which enable quick tracing of the trading partner with ease (Johnson, 2020). They help in giving currency quotes to many other dealers and hence making it easy for inter-bank traders to carry out forex.

The central bank is another pivotal player in the foreign market involving the varied industries. As evident, the central banks consistently take the initiative to stabilize the exchange rates through domestic currencies while ensuring that the currency incredibly operates within the desired range or gradually fluctuates within the estimated range (Engel, 2019). However, the bank's intervention is highly determined by the noticeable exchange rate systems managed by the given country's central bank.

Multinational Cooperation is another essential player in the FOREX markets; mainly in the forward marketplace, MNCs help in exchanging cash risks. As evident, MNCs frequently contract to meet to get fixed amounts in FOREX rates, which increasingly exposes them to foreign currency risks (Engel, 2019). Herein, the MNCs frequently opt to avoid future exchange risks through via the inter-stores forward exchange markets. Another key player in the FOREX market is individuals and small businesses. These parties apply the FOREX markets to enable

the completing transactions (Johnson, 2020). Individuals and small businesses are core players, and they require small accounts for a proportion of FOREX transactions. However, individual and small business are quite essential players in the forex markets, and they are often used to hedge FOREX risks.

The Foreign Exchange Quotation

FOREX quotation refers to an identical approach in which relative exchange rates are quoted for trade amid players in the currency market (Sato, 2019). There are three major approaches to foreign exchange quotation, and these include:

i. Direct Quotation

In this approach, the direct quotation comes out as the cost of one unit imported currency estimated in comparison to a country's foreign currency (Sato, 2019). In more concentric terms, a direct quotation implies the country's domestic currency that is required to buy an additional unit of another country's currency. For instance, USD to Euro is a direct quote.

ii. Indirect Quotation

The indirect quotation comes out as a reverse approach of a direct quotation. In this case, the concerned parties take value of one unit of domestic funds quoted in regards to imported currency (Sato, 2019). It is concerned with the amount of domestic currency that it would take to get one unit of the overseas currency. For instance, a quotation 2.00 per USD is an indirect quotation for the USD

iii. Cross Rate

This method of financial quotation entails the interaction amid banks and non-bank customers in any convertible currency. In this concern, the exchange rate for any non-dollar currencies is computed or derived from their respective dollar exchange rates (Chinn, 2019). In

other words, cross rates come out as the rates between two currencies where both currencies where neither of them is a domestic currency to the nation.

The Purchasing Power Parity (PPP) pays attention to the influence of the different nation's price levels to the current and future exchange rate. Analytically, a nation's rate of inflation skyrockets in relation to that of other nations (Sato, 2019). There exist two types of PPP, which include the relative and absolute PPP, which are actively altered when exchange rates are varied.

The concept of absolute PPP implies that the net-worth of a product remain the same in diverse countries should remain the same when estimated in a common type of currency (Sato, 2019). For instance, consider using dollar- to-British exchange. The affiliated absolute PPP can be expressed as an equality price for both nations expressed as $P(\text{U.S.}) = P(\text{UK}) \times E$. On the other hand, absolute PPP comes in effect when the dollar-British pound interchange reflects the proportion of the price levels in the U.S (P_{us}) in addition to the U.K. (P_{uk}).

The relative PPP illustrates that the gradual fluctuations that the changes in the dollar-British pound exchange rate match in the proportions of the United States price level ($P_{\text{U.S.}}$) and United Kingdom price level $P(\text{UK})$. As an economist, there is a need to note the ideal difference amid the relative PPP and absolute PPP (Menkhoff & Stöhr, 2017). The absolute PPP illustrates that FOREX rates should be in line with the ratio of two countries' currency and price levels accordingly. Notably, every promising market is featured with market imperfections, which include transportation costs, quotas, tariff, and non-transferable inputs, among others. In this concern, relative PPP considers these market inadequacies then takes the initiative to relax affiliation amid the FOREX rates to the price levels of different nations via examining the

linkage amid the changes in the exchange rates as well as alterations in the proportion the different price levels.

The relationship amid interest rates and exchange rates

Analytically, the interest rates as well as exchange rates have no direct correlations with each other. However, they suitably impact each other in varied ways. According to economists, high-interest rates imply that the nation's currency has gained value (Bloom, 2019). From a foreign investor's point of view, investing, or saving in such a country, one is likely to yield more profitable returns, leading to a rapid increase in demand for that domestic currency. For investors to fetch the benefits of the high rates offered, they would move much of their funds there, leading to the increased strength of the currency. By so doing, the affiliated exchange rate improves. An increase in the strength of currency benefits the importer and disadvantages exporters.

Conversely, when a country's interest rate tends to be low, the currency becomes less valuable, and hence the attached demand in the FOREX market diminishes (Bloom, 2019). This facilitates currency devaluation and leads to significantly reduced exchange rates as opposed to other stronger currencies. It leads to an increased supply of domestic currency, leading to increased inflation, reducing the purchasing power of the currency.

From a general perspective, theories and relationships are essential for multinational business managers. The theories help multinational business managers to apprehend macroeconomics in theory. The relationships between domestic interest rates and foreign exchange rates help multinational business managers understand their own profiles (Bloom, 2019). Multinational business managers are in a position to understand loans and credit card payments. Managers are in a position to define the most attractive interest rates. Multinational

business managers will be in a position to define when to cut business spending while increasing productivity. The relations help managers manage their debts when the interest rates fall with an aim to maintain their profitability (Bloom, 2019). More importantly, multinational business managers are in a position to learn how best to hedge foreign currency. In more concentric terms, multinational business managers are able to understand the most appropriate approaches to buy or sell foreign goods as well as foreign currencies through favorable exchange rates.

Impacts of Exchange Rates

Evaluating forecasting for exchange rates is defined by a couple of factors. One of the leading impacts of exchange rates is inflation, which implies the general costs for goods and services increasing above the inflation rate (Bloom, 2019). When the FOREX rate is high, the purchasing power of the nation's currency decreases while low inflation rates increase the value of the currency, and hence multinational business managers are in a position to define whether to buy more or sell more.

The interest rate is another factor that impacts the aspect of estimating trends of exchange rates. As such, high-interest proportions make the domestic currency more attractive and impact in an appreciation of a currency in relation to other countries (Bloom, 2019). Fluctuation in interest rates helps a multinational business manager to define where to invest so as to give desirable returns to the entire firm.

Another impact of exchange rates is the aspect of speculations. Arguably, rumors about changes in the prices of a commodity make a nation's currency depreciate actual value and hence giving a forecast of exchange rates (Chinn, 2019). For this reason, multinational business managers stand a chance to accurately understand the affiliated sentiments in the financial

markets to heavily challenge the foreign exchange rates through market alerts concerning the possibilities of an interest rate valuation or devaluation.

Another impact of exchange rates is that of the balance of payments, which play a pivotal role in the forecasting of foreign exchange rates. According to economists, when the cost of imports is higher as opposed to exports, and hence posing an implication that there exists a shortage in the current account (Chinn, 2019). Herein, multinational business managers will gain the understanding that a deficit is a result of increased spending on imports than exports. Therefore, the manager should focus on selling more goods to a country that spends more on imports for increased profitability.

Another critical impact of the exchange rate that helps in the accurate evaluation and forecasting of exchange rates of a country. As evident, the country's debt rating challenges its currency exchange rates. A multinational business manager is less expected to make a choice and invest in the countries which have a huge public deficit in addition to government debts (Chinn, 2019). For this reason, managers might consider investing in countries with high debt ratings based on the fact that governments might opt to sell their bonds as a low price in fear of a debt default.

In conclusion, the FOREX market is the backbone of every sovereign nation because it defined the stability of an economy. Arguably, an increase in the real exchange rate implies that citizens in a nation have the power to purchase more of imported goods at an equal cost to the cost of domestic goods. Considerably, an upsurge in the real exchange rate causes an ideal increase in the total value of imports (Johnson, 2020). As a nation, there is a need to focus on the important roles of the FOREX market within an economy and ensure improved operations within an economy. For that reason, multinational business managers must pay attention to the ideal

implications of both absolute PPP and relative PPP as well as the affiliation between exchange rates and foreign exchange rates.

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