



# **Module-D Unit-5**

## **JAIIB PAPER-1**

**Indian Economy and Indian  
Financial System (IE & IFS)**



## JAIIB Paper 1 IE & IFS Module D Unit 5 - Foreign Exchange Market

### Profile Of Foreign Exchange (Forex) Market

In terms of **Section 2(n) of FEMA, 1999**, the definition of 'foreign exchange' is as follows. *"Foreign exchange" means foreign currency and includes:*

- Deposits, credits and balances payable in any foreign currency,
- Drafts, travellers' cheques, letters of credit or bills of exchange, expressed or drawn in Indian currency but payable in any foreign currency,
- Drafts, travellers' cheques, letters of credit or bills of exchange drawn by banks, institutions or persons outside India, but payable in Indian currency".

The forex market has developed as a consequence of the international trade and foreign exchange requirement of nations. It is primarily an over-the-counter (OTC) market, although there are exchange traded transactions, as well, in the segments of futures.

### Evolution Of The Forex Market In India

- **1978:** RBI allow banks to undertake intra-day trading in foreign exchange.
- As a consequence, the stipulation of maintaining **"square" or "near square"** position was to be complied with only at the close of business each day.
- During the period 1975- 1992, the exchange rate of rupee was officially determined by the RBI, in terms of a weighted basket of currencies of India's major trading partners and there were significant restrictions on the current account transactions.
- **July 1991:** Significant two-step downward adjustment in the exchange rate of the rupee on July 1 and July 3, 1991, with a view to placing it at an appropriate level in line with the inflation differential to maintain the competitiveness of exports.
- Following the recommendations of the High-Level Committee on Balance of Payments (**Chairman: Dr C. Rangarajan**):
- **Mar 1992:** The Liberalised Exchange Rate Management System (LERMS), involving dual exchange rate mechanism was instituted, which was followed by the ultimate convergence of the dual rates.
- **Effective from March 1, 1993 (known also as modified LERMS).**
- The unification of the exchange rate of the rupee marks the beginning of the era of market determined exchange rate regime of rupee, based on demand and supply in the forex market.
- It is also an important step in the progress towards current account convertibility, which was finally achieved in August 1994, by accepting **Article VIII of the Articles of Agreement** of the International Monetary Fund.

- **November 1994:** The appointment of an Expert Group on Foreign Exchange (**popularly known as Sodhani Committee**), was a landmark in the design of foreign exchange market in India.
- **Recommendations:** To develop, widen and deepen the forex market. Banks have been accorded significant initiative and freedom to operate in the market.
- This led to increasing turnovers in the forex market which rose from approximately USD 6 billion daily in the year 2000 to USD 70 billion daily, at present.

### **Characteristics Of The Forex Market**

- **Liquidity:** The market operates the enormous money supply and gives absolute freedom in opening or closing a position in the current market quotation. High liquidity is a powerful magnet for any investor, because it gives the freedom to open or to close a position of any size whatever.
- **Promptness:** With a 24-hour work schedule, participants in the forex market need not wait to respond to any given event, as is the case in many markets.
- **Availability:** A possibility to trade round-the-clock; a market participant need not wait to respond to any given event.
- **Flexible regulation of the trade arrangement system:** A position may be opened for a pre-determined period of time in the forex market, at the investor's discretion, which enables to plan the timing of one's future activity in advance.
- **Value:** The forex market has traditionally no service charges, except for the natural bid/ask market spread between the supply and the demand price.
- **One-Valued quotations:** With high market liquidity, most sales may be carried out at the uniform market price, thus enabling to avoid the instability problem existing with futures and other forex investments where, limited quantities of currency only can be sold concurrently and at a specified price.
- **Market trend:** Currency moves in a quite specific direction that can be tracked for rather a long period of time. Each particular currency demonstrates its own typical temporary changes, which presents investment managers with the opportunities to manipulate in the forex market.
- **Margin:** The credit "leverage" (margin) in the forex market is only determined by an agreement between a customer and the bank or the brokerage house that pushes it to the market and is normally equal to 1:100.

### **Market Participants**

- **Commercial banks and investment banks:** They generally act on their own behalf or based on the needs and interests of their clients.
- **Brokers:** They act as intermediaries between financial institutions or as links with private individuals, in exchange market, for a fee.

- **Central banks:** Central banks like RBI are responsible for issuing their respective country's currency and managing and controlling the money supply. Central Banks therefore intervene in currency markets – individually or in a coordinated way – to keep the value of their currencies within the limits defined by their monetary policies.
- **Sovereign funds:** These are public investment funds that invest proceeds from business privatisations, natural resources (oil, gas), etc., in foreign currency assets.
- **Hedge funds and investment entities:** These entities intervene in foreign exchange markets, with speculative purposes or to obtain returns. Multinationals, large corporations and SMEs and institutional investors (such as insurance companies and asset managers):
  - These engage in exchange markets for commercial or investment purposes.
- **Individuals:** They operate in the foreign exchange market, for transactional hedging or speculative purposes.

### **Libor And Alternate Reference Rates (ARRs)**

- London Inter Bank Offered Rate or LIBOR was a very popular benchmark and was issued for US Dollar, British Pound, Euro, Swiss Franc, Canadian Dollar and the Japanese Yen.
- The rate was being calculated and published each day by the ICE Benchmark Administration (IBA).
- The LIBOR had come into a great amount of criticism and irregularities, as a result of which, steps were taken to replace it as a financial benchmark rate.
- The events of '**LIBOR rigging**' created shock waves in the financial system and the credibility of a financial reference used to price and determine payoffs for trillions of dollars of loans/bonds/derivatives came under a cloud.
- In response to these developments, the UK commissioned a review of the **structure and governance of LIBOR**.
- The review concluded that LIBOR should be retained as a benchmark but that it should be comprehensively reformed.
- It also recommended that the publication of LIBOR in certain currencies and maturities in which the volumes of trades were particularly low should be discontinued.
- However, since these steps did not generate the required confidence for a universally acceptable benchmark rate,
- it was decided to phase out the LIBOR and replace it with the Alternate Reference Rates (ARRs) by 31st December, 2021.

### **Foreign Exchange Dealers' Association Of India (FEDAI)**

- FEDAI is one of the very important institutions connected with the forex market and foreign exchange transactions in India.
- The **Foreign Exchange Dealers'** Association of India (FEDAI) is an association of banks that are authorised to deal in foreign exchange markets in India. Established in the year 1958, the body regulates the rules that determine various aspects of operations and charges that are attached to the foreign exchange business.
- In addition to rule setting, FEDAI assists member banks, by acting as an advisor and assists with the training of banks' personnel and accrediting foreign exchange brokers.

#### **FEDAI has a number of functions, which are as follows:**

- Issuing of guidelines and rules for handling of foreign exchange business,
- Training of bank personnel in the areas of foreign exchange,
- Accreditation of forex brokers,
- Advising/assisting member banks in settling issues/matters in their dealings,
- Representing member banks on Government/Reserve Bank of India/Other Bodies, and
- Announcement of daily and periodical rates to member banks.

### **Foreign Exchange Management Act (FEMA), 1999**

- First time introduced through a series of rules, **under the Defense of India Act, 1939, on temporary basis.**
- **An Act was promulgated in the statute under the title "Foreign Exchange Regulation Act, 1947".**
- Subsequently, this Act was replaced by the **Foreign Exchange Regulation Act, 1973 (FERA) which came into force**
- With effect from January 1, 1974 and regulated **foreign exchange for more than 26 years under this Act.**
- Economic liberalisation in the year **1991, foreign investment in many sectors were permitted in India.**
- **In 1997: Tarapore Committee** on Capital Account Convertibility, constituted by the Reserve Bank of India.
- **Recommendation:** Changes in the legislative framework, governing foreign exchange transactions
- Accordingly, the **Foreign Exchange Regulation Act, 1973 was repealed and replaced by the new Foreign Exchange Management Act, 1999 (FEMA), with effect from June 01, 2000.**

- **Under FEMA, the** emphasis was on management, rather than on regulation, of foreign exchange.

### Applicability of FEMA

- **FEMA, 1999**, was enacted to consolidate and amend the law relating to foreign exchange,
- **Objective:** Facilitating external trade and promoting the orderly development and maintenance of foreign exchange market in India.
- **Applies:** To all branches, offices and agencies outside India owned or controlled by a person resident in India and also to any contravention committed thereunder outside India, by any person to whom this Act applies.

### Overall Structure

- **The overall structure of FEMA, 1999, is** covered by legislations, rules and regulations.
- **Contains 7 chapters divided into 49 sections.**

### Authorities and Enforcement Machinery

FEMA in itself is not an independent and isolated law. The provisions of FEMA are spread at different places and so there are several regulatory bodies. Reserve Bank of India makes Regulations under FEMA and the Rules are made by **the Central Government. Authorities governing the enforcement of FEMA are:**

- Foreign Exchange Department, Reserve Bank of India.
- Directorate of Enforcement, Department of Revenue, Ministry of Finance.
- Capital Market Division, Department of Economic Affairs, Ministry of Finance.
- Foreign Trade Division, Department of Economic Affairs, Ministry of Finance.

### Machinery responsible for various aspects of FEMA

- Enforcement Directorate
- Adjudicating Authorities
- Special Director (Appeals)
- Appellate Tribunal

### Important Provisions of the Act

**Section 3** – It prohibits dealings in foreign exchange except through an authorised person. This Section states that no person can, without general or special permission of the RBI:

- Deal in or transfer any foreign exchange or foreign securities to any person not being an authorised person.
- Make any payment to or for the credit of any person resident outside India, in any manner.

- Receive otherwise through an authorised person, any payment by order or on behalf of any person resident outside India, in any manner.
- Enter into any financial transaction in India as consideration for or in association with acquisition or creation or transfer of a right to acquire any asset outside India by any person.

**Section 4** – It restrains any person resident in India from acquiring, holding, owning, possessing or transferring any foreign exchange, foreign security or any immovable property situated outside India except as specifically provided in the Act. The terms “foreign exchange” and “foreign security” are defined in sections 2(n) and 2(o) respectively of the Act. The Central Government has made Foreign Exchange Management (Current Account Transactions) Rules, 2000.

**Section 6** – It deals with capital account transactions. This section allows a person to draw or sell foreign exchange from or to an authorised person for a capital account transaction. RBI in consultation with Central Government has issued various regulations on capital account transactions, in terms of sub-section (2) and (3) of section 6.

**Section 7** – It deals with export of goods and services. Every exporter is required to furnish to the RBI or any other authority, a declaration, etc., regarding full export value.

**Section 8** – It casts the responsibility on the persons resident in India who have any amount of foreign exchange due or accrued in their favour to get the same realised and repatriated to India, within the specific period and the manner specified by RBI.

**Sections 10 and 12** – These provisions deal with duties and liabilities of the authorised persons. Authorised person has been defined in Section 2(c) of the Act, which means an authorised dealer, money changer, offshore banking unit or any other person for the time being authorised to deal in foreign exchange or foreign securities.

**Sections 13 and 15** – Provisions of these sections deal with penalties and enforcement of the orders of Adjudicating Authority as well power to compound contraventions under the Act.

**Sections 36 and 37** – These pertain to the establishment of Directorate of Enforcement and the powers to investigate the violation of any provisions of Act, rule, regulation, notifications, directions or order issued

### **Fx-Retail Platform**

- **The Reserve Bank of India, in its “Statement on Developmental and Regulatory Policies”** dated October 04, 2017, had stated
- Mechanism should be in place, for improving the pricing outcome for the “**Retail User**” under which, client pricing is directly determined in the market by providing customers with access to an inter-bank electronic trading platform, where bid/offers from Retail clients and Authorised Dealer banks can be matched anonymously and automatically.

- **According to RBI, a mechanism in the form of a trading platform:** Provide the much-needed transparency and at the same time, enhance competition and lead to better pricing for the customers.
- Further, direct execution of orders by the customer would also bring down the risk that banks face in warehousing transactions, until they can be aggregated to a market- lot.
- In this mechanism, the banks may charge their customers a pre-agreed flat fee, towards administrative expenses [should be disclosed to the customer by the bank]
- Overall, a trading platform shall bring down the total cost faced by the retail customer, in the foreign exchange market.
- RBI in its “**Statement on Developmental and Regulatory Policies**” dated June 06, 2019 announced the introduction of a Foreign Exchange Trading platform for buying and selling foreign exchange for the customers of Banks.
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