INTERNATIONAL JOURNAL OF INNOVATIVE RESEARCH & DEVELOPMENT

ISSN 2278 – 0211 (Online)

Indian FOREX Market: A Malnourished Baby in the Global FOREX Market

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Abstract:
With the formation of International Monetary Fund, Forex market was emerged as a unique services market. It is a distinct trading market where awareness about market is the only way to make money to contribute in your concerned economy. Since inception of this market, US Dollar was the central unit of account and vehicle currency for settlement of international transactions. Still US Dollar has an unbeaten dominance with around 87% share in global Forex market.
In India, examples of forex trades in ancient period are businesses through silk route, export of carpets to Arabian countries or export of spices to European continent. But a formal Forex market existed since 1973 when India introduced the Foreign Exchange Regulation Act (FERA). Now the market has completed almost four decades, but still its share in global market is non recognizable.
In this paper we explore the dynamics of Indian forex market. We will analyze global presence of this market after FERA /FEMA regime. We will explore the possibility to promote Rupee-dominated export to make this market more vibrant along with the awareness of Indian citizen about this more profitable product.
The analysis has several limitations that should be kept in mind when giving the conclusion. One of such limitation is limited availability of authentic data on global foreign exchange market. We plan to address this limitation in our future work. We expect that the basic intuition developed in this paper will offer an opportunity to more research on the concerned topic.

1. Global Forex Market

1.1. Introduction

Global foreign exchange market turnover has grown at around 217%[1] in last fifteen years (as shown in below picture). In 2013, global foreign exchange market turnover was around USD 6,671 billion (based on daily averages in April). United Kingdom and United States are two

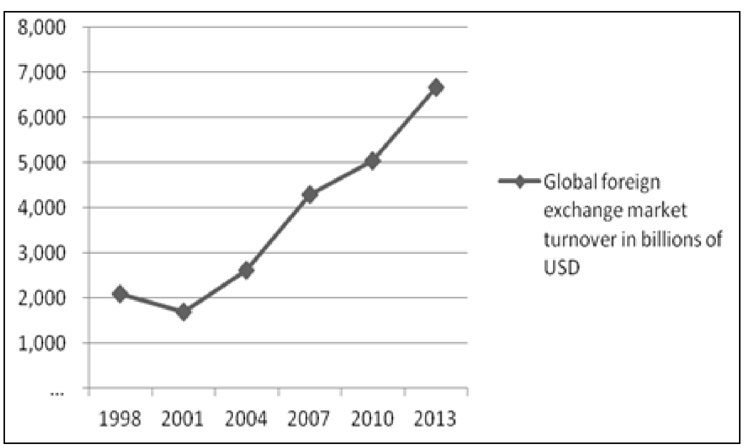

Figure 1: Growth of Global Foreign Exchange market

[1] Based on Global foreign exchange market turnover 2013 report (Triennial Central Bank Survey) by Monetary and Economic Department of Bank for International Settlements leading countries who are having around 50% share in this market in last fifteen years. United Kingdom is leading the tally with 30 to 40% share whereas India's share in the same period is mere 0.1 to 0.9%. United States is the second contributor in the market with 16 to 19% share.

If we analyze currency distribution of global foreign exchange market tutnover in last fifteen year, we will find that market is skewed towards four major currencies US Dollar, Euro, Japanese Yen and Pound Sterling. Still all four are having around 75% of total turnover.

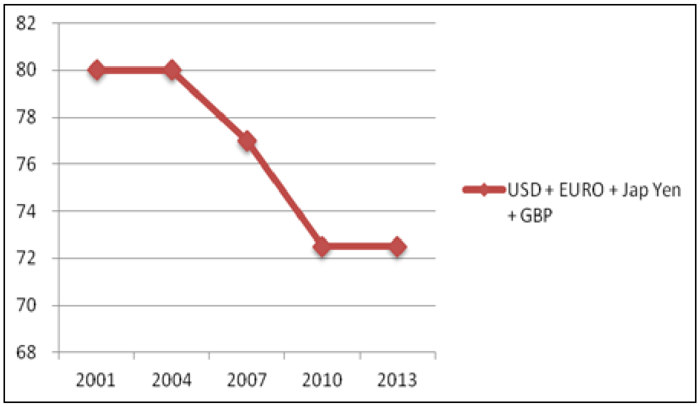

Figure 2: % of Four Major Currencies

1.2. Strong Link

There is a direct link between the share of all four currencies with the growth of the global foreign exchange market. In last fifteen years, contribution of US Dollar is 42 to 45%, EURO is 16.7 to 19.5%, Japanese Yen is 8.6 to 11.8% and of GBP is 5.9 to 8.3%. As the share of the corresponding currencies increases, appreciation[2] of that particular currency is obvious. Almost 75% appreciation of USD against INR observed in last 14 years. In the same period, only 3.5% appreciation observed in case of Pound Sterling against INR, 80% appreciation in case of Euro against INR and 20% observed in case of Japanese Yen against INR.

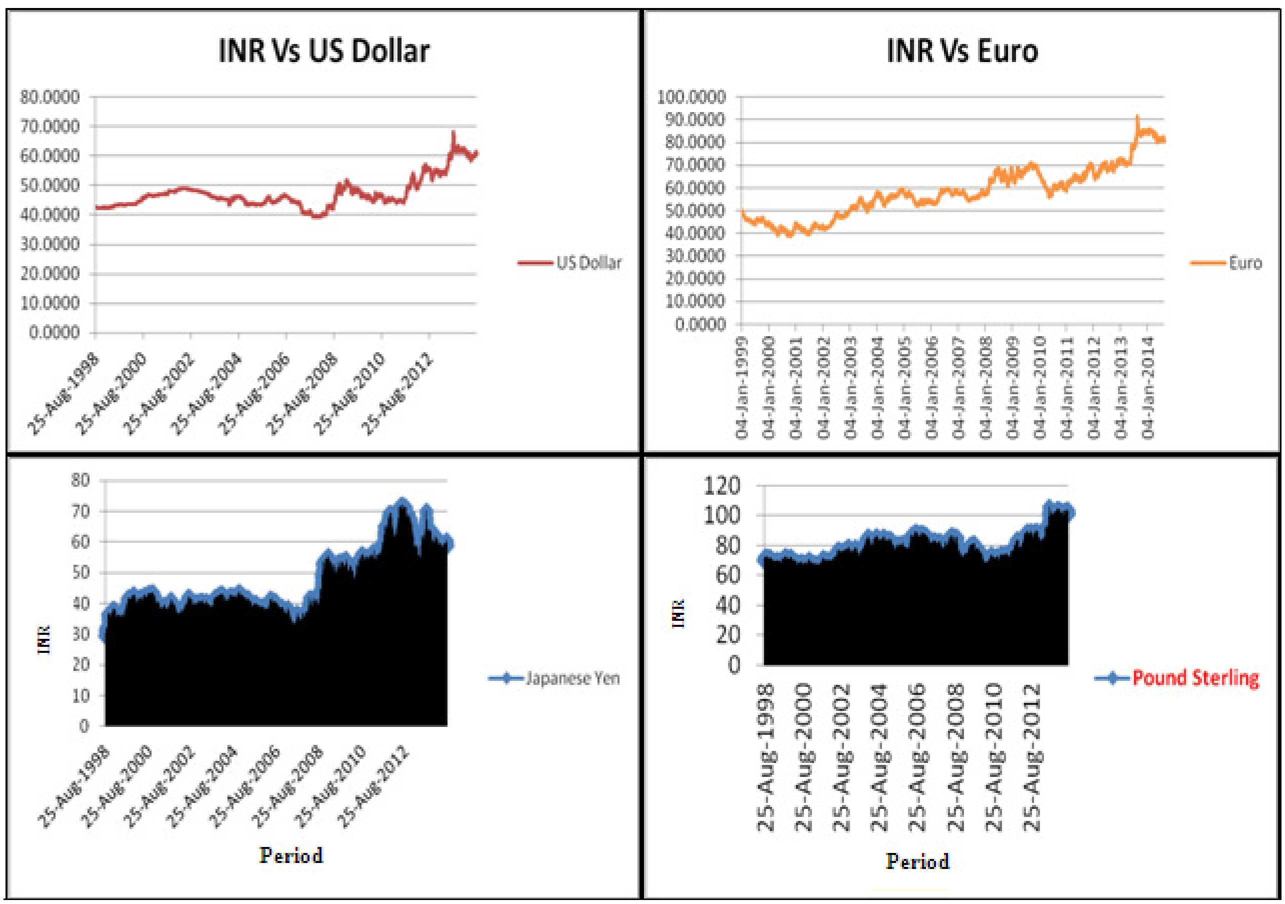

Figure 3

[2] Based on Daily Exchange Rate of the Indian Rupee relesaed by RBI in August 2014

The interpretation is based on four figures [upper] and one figure [below].

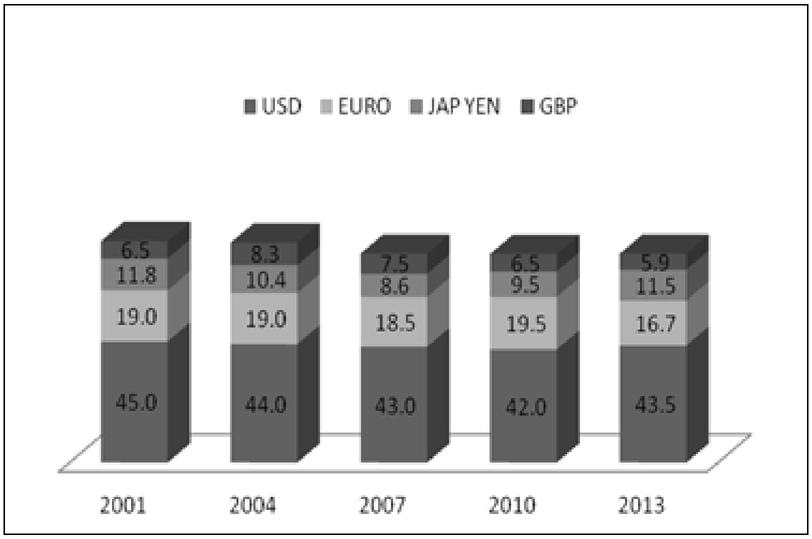

Figure 4

Though the contribution of all four major currencies is almost stable with some minor variations in last decade, but the global forex market size has grown at a very faster pace. So the contributions from all four currencies have been increased in that aspect.

1.3. Foreign Exchange Instruments

Five types of Forex instruments are being traded in Global foreign exchange market –Foreign exchange swaps[3], Spot transactions[4], outright forwards[5], Options & other products and Currency swaps. Out of five, FX swaps and Spot transactions are most traded and Currency swaps are least traded instruments. In 2013, share of FX swaps was at 42%, Spot transactions was at 38%, outright forwards were at 13%, Options was at 6% and Currency swaps was at 1%.

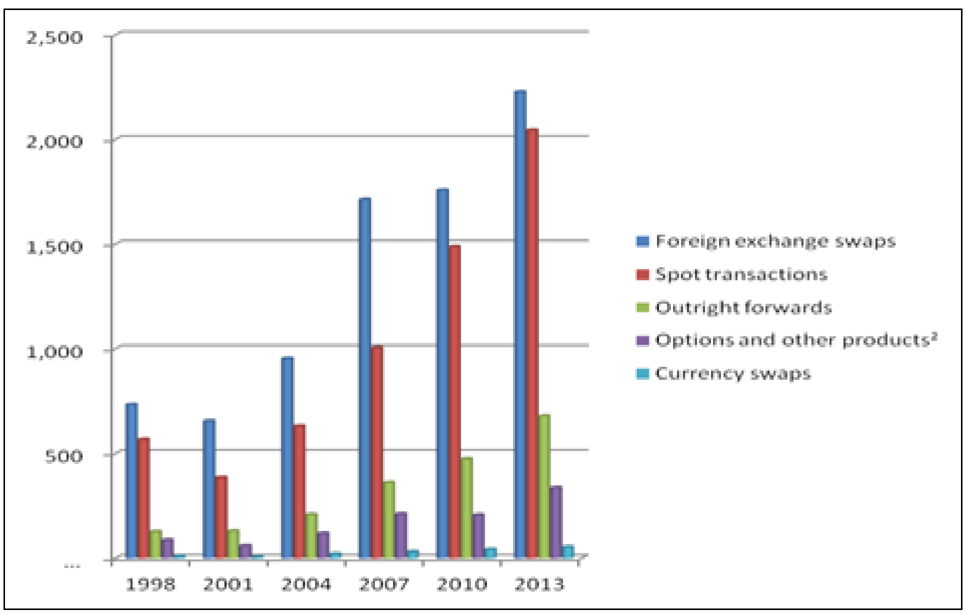

Figure 5

1.4. Global Forex Market Turnover by Currency Pair

In global forex market, only three currency pairs are having more than 50% share in all transactions. Topper in the list is USD/EUR with 24.1%, followed by USD/JPY with 18.3% and USD/GBP with 8.8%. Indian Rupee (INR) is not making any significant currency pair except USD/INR which is holding 17th rank in the list with 0.9% in April 2013.

[3] Swap transaction involves simultaneous purchase and sell of currency for different periods
[4] Spot transaction settles two days subsequently
[5] Forward transaction settles at a specified future date

1.5. Participants in Forex market

It is a 24-hour market as the markets are situated throughout the different time zones of the globe. It is an OTC[6] market with banks operating in a centre connected through telecommunication. Participants in this market are corporate (as retail customer), commercial banks (major player of the market), exchange brokers (facilitate deal between banks) and the central bank of the country (to influence the exchange rate). Settlement of transactions is being done through some institutions and arrangements like SWIFT, CHIPS, CHAPS and Fedwire.

2. Indian Foreign Exchange Market

After independence, Indian government has adopted the socialistic way of managing business and introduced license raj to run Indian companies. So 'Made in India' brands were non competitive in the international market, leading to decline in export. Simultaneously India import bill of capital goods, crude oil & petrol products increased the forex outgo. Settlements in both terms were in USD, so resulted in severe scarcity of foreign exchange.

The Foreign Exchange Regulation Act (FERA) enacted in 1973. As per the guidelines, all forex earnings by companies and residents have to reported and surrendered (immediately after receiving) to RBI (Reserve Bank of India) at a rate which was mandated by RBI. FERA strictly

Controlled any activities related to foreign exchange. Forex market in India formally initiated in 1978 when Central government allowed interbank foreign exchange trading. At that time, Indian forex market has been a highly regulated one.

Post liberalization, the Government of India felt the necessity to liberalize the foreign exchange policy. Hence, Foreign Exchange Management Act (FEMA) 2000 was introduced. FEMA expanded the list of activities in which a person/company can undertake forex transactions, liberalized the export-import policy, limits of FDI (Foreign Direct Investment) & FII (Foreign Institutional Investors) investments and repatriations, cross-border M&A and fund raising activities.

Prior to 1992, Government of India strictly controlled the exchange rate. After 1992, Government of India slowly started relaxing the control and exchange rate became more and more market determined. Foreign Exchange Dealer's association of India (FEDAI), set up in 1998, helped the government of India in framing rules and regulation to conduct forex exchange trading and developing forex market in India. Since 2001, clearing and settlement functions in the foreign exchange market are largely carried out by the Clearing Corporation of India Limited (CCIL).

Another major development of Indian forex market happened in 2008, when currency futures (Indian Rupee and US Dollar) started trading at National Stock Exchange (NSE). Since the introduction, the turnover in futures has increased leaps and bound. Though banks and authorized dealers were undertaking forex derivatives contracts, but the introduction of exchange traded currency futures marked a new beginning as the retail investors were able to participate in forex derivatives trading.

As per Triennial Central Bank Survey of Bank for International Settlements (2013), India's positioning in global forex market [Rank and share] - in 1998 - 35th [0.1%], in 2001 – 31st [0.2%], in 2004 – 27th [0.3%], in 2007 – 16th [with 0.9%], in 2010 -20th [0.5%] and in 2013 – 20th [0.5%]. Turnover of Indian foreign exchange market can be seen in below figure :-

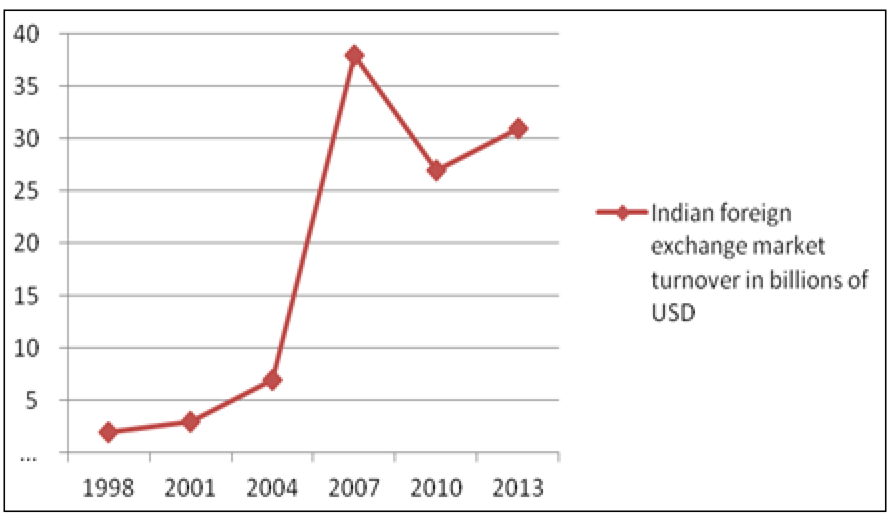

Figure 6: Growth of Indian Foreign Exchange Market

During 2003-04 the average monthly turnover in the Indian foreign exchange market was about 175 billion US dollars which has been increased up to 790 billion US dollars in April 2013 (almost 350% growth in last 10 years). So now the sheer size of the foreign exchange market becomes evident. In India too, foreign exchange constitutes the largest financial market by far. In 1978 with entry of banks to trade foreign exchange with one another, Indian Forex market started its operation. Out of all five Forex instruments traded in India, Outward forward is the most traded instrument.

[6] Over the counter where no physical place is existing to execute deals of participants.

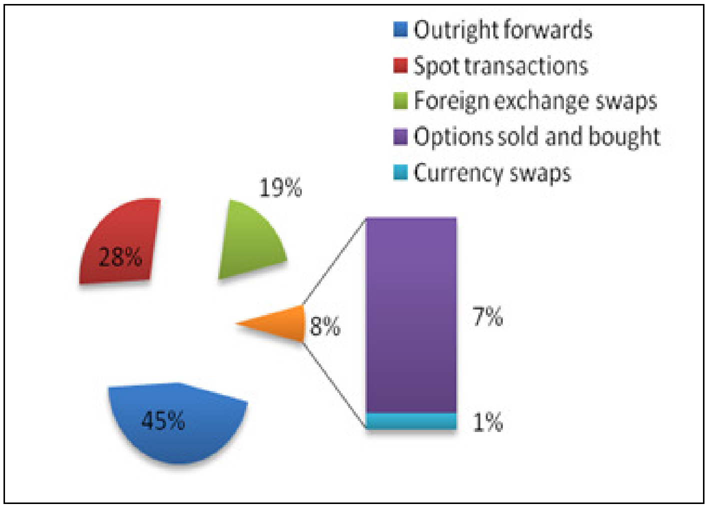

Figure 7: Instruments in India Forex Market in 2013

Today over 60%[7] of the trading in foreign exchange continues to take place with reported dealers (preferably Banks). But an interesting analysis is that the instrument which is most traded in market, trading is least being done with reported dealers.

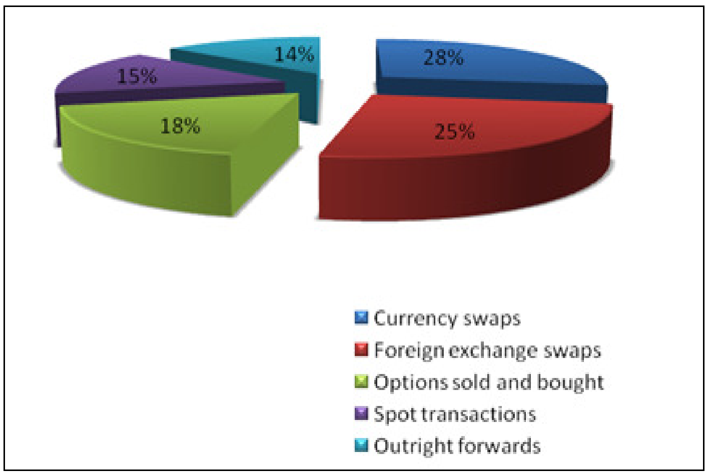

Figure 8: Trading with reported dealers in India

2.1. Role of RBI in Indian Forex Market

Indian foreign exchange market is divided into two segments – *wholesale segment*, where the dealings take place among the banks and *the retail segment,* which refers to the dealings that takes place between banks and their customers.

In India, most of the forex trading is in wholesale segment. Retail segment is in nascent phase here. Reserve Bank of India intervenes in this market only to influence the exchange rate. Otherwise it does not enter in the market in the ordinary course. Authorized dealers are recourses to RBI to sell or buy US Dollar to the extent the latter is prepared to transact in the currency at the given point of time. The Reserve Bank of India has used a varied mix of techniques in intervening in the foreign exchange market – indirect measures such as press statements and, in more extreme situations, monetary measures to affect the value of the rupee as well as direct purchase and sale in the foreign exchange market using spot, forward and swap transactions[8].

2.2. Awareness about this Product

Awareness of this retail product in India is as a service, not as a product, because in a forex transaction one party offers to another an intangible thing which cannot be owned by the participant. Leading forex market in India is Mumbai followed by all three metros. Now Kochi, Bengaluru, Ahmadabad and Goa are new entrants in this market. So basically the product is almost restricted to metros only. Major players are commercial banks and they are doing their bulk business through designated branches in selected cities. Commercial banks along with Reserve Bank of India are of conservative nature in opening this market to common man. Indian forex market is still a malnourished baby in global forex market.

[7] RBI Bulletin
[8] RBI Bulletin

3. Recommendations

But a lot of opportunities are available for Indian forex market. To make a big presence in the global forex market, following steps should be taken forward -

1. RBI's two intervention in this market will be helpful - Quantitative restrictions on trade and cross-border transfer of capital and Periodic trades by the central bank of the country or its allies and agents so as to move the exchange rate in the desired direction.
2. Rangarajan committee recommendation about flexible exchange rate system should be introduced.
3. The Tarapore Committee report had urged more transparency in the intervention process and recommended, in 1997, that a 'Monitoring Exchange Rate Band' of ± 5% be used around an announced neutral real effective exchange rate (REER), with weekly publication of relevant figures, something yet to be implemented[9]
4. Capital Account Convertibility as recommended in 1997 by the Tarapore committee should be adopted. It defined the concept as "the freedom to convert local financial assets into foreign financial assets and vice versa at market determined rates of exchange".
5. India is now having a sizable foreign exchange reserve. It acts as liquidity cover and protects against a run on the country's currency, and reduces the rate of interest on Indian debt in the world market by lowering the country risk perception by international rating agencies. However, beyond a point, it begins to affect the money supply in the country, and interest rates. It should be under control.
6. We observed the lesser depreciation in export/import value against comparatively strong currency. So rupee-based export should be promoted in India. It will be more relevant whenever Indian Rupee will lose its reputation.
7. Customer empowerment should be the key for making Desi presence in the global foreign exchange market.

4. Conclusion

India is inching towards a major financial super power. Country has an over-abundance of foreign exchange reserves, imports are no longer viewed with fear and skepticism. Country is doing deals on terms of paying partially in Indian Rupee. Growth rate is adequate. The Reserve Bank of India and its allies now intervene occasionally in the foreign exchange markets not always to support the rupee but often to avoid an appreciation in its value. As foreign trade and cross-border capital flows continue to grow, and the country moves towards capital account convertibility and full convertibility of the rupee is clearly visible in the horizon. These developments are very positive signs for the explosive growth of forex market in India with largest retail customer base in global forex market. If it will be possible, then the foreign exchange market is bound to play an even greater role in the Indian economy.

We propose further study of the issue in another research like to investigate the awareness level of forex products in all states as well as in all urban areas with the same methodology applied in this research.

5. Research Priorities

There is much we do not know about the outcome of the analysis, but future research in this area would address 3 questions: -

1. Recognizable positioning of Indian Forex Market in Global Foreign exchange market
2. Behavior of Rupee against other major currencies [Asian Countries/Euro/US$] to analyze the Market and suggest the rupee dominated export for further business moves
3. Possibility to adopt an Asian currency like Euro for federation of all Asian countries

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