CHAPTER 2

BASIC CONCEPTS OF FOREIGN EXCHANGE

INTRODUCTION

Development in International trade is a prerequisite for world economic development and stability. The term foreign exchange involves the conversion of foreign currency to Indian rupees through a negotiable instrument,

- Cable
- Mail transfer
- Letter of Credit
- e-transfer

Banks dealing in foreign currency are called authorized dealers (AD) under India's apex bank, Reserve Bank of India.

When we import, we pay in foreign currency converted into Indian currency at the rate prevalent on the date of settlement. In the same way, when we export, we get Indian rupee through Bankers determined at the rate prevalent on the date of settlement. The foreign exchange rates between Indian rupee and currency of any other country are determined on day-to-day basis.

Fluctuations in foreign exchange are taken care of at national level by ADs and RBI.

An Indian resident, who is dealing, day in and day out in various commodities and to buy and sell them, uses legal currency of India i.e., Indian Rupee. But to buy and sell commodities and services, if he has a currency, which is other than his country's currency, what will happen? Say for example, an Indian resident receives US Dollar 1,000 from his relative, for using in India, he cannot straightaway use the Dollar, but has to convert in Indian Rupees and use it to buy commodities/services.

Hence can we define Foreign Exchange in the following manner?

1. The currencies of other countries in the form of Currency Notes, Travellers’ Cheques, Drafts, Electronic Transfers, etc.
2. The mechanism by which our legal tender is converted into another currency and vice versa.

Why Conversion is necessary?

Conversion of currencies with each other has become a necessity. Because no country in this Universe can claim that they manufacture all the goods and services that their people require to consume. Even the mighty USA is no exception. They import Coffee from Brazil, India, etc. for their consumption. Similarly India imports Capital goods, Technology, etc. from Western Countries.

All are aware that there is no Universal Currency through which such settlements across the national barriers and borders could be made and settlements take place in the sellers'/ buyers'/any mutually accepted currency. Hence the invention of conversion mechanism.

Why Exchange Control?

India is having the following Inflows and Outflows:

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<th>INFLOWS</th>
<th>OUTFLOWS</th>
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<td>Inward Remittances</td>
<td>Outward Remittances</td>
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<td>Remittances to all bank accounts</td>
<td>Payments relating to imports</td>
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<td>Foreign Aids/Loans/Borrowings by</td>
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<td>Corporates, etc.</td>
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<td>Export Receivables</td>
<td>Tour/Travel related expenses</td>
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<td>Tourists' income</td>
<td>Loan repayments/servicing of loans</td>
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Normally in India, there is a shortfall of inflows than outflows. Our import payments are very crucial for the country's economy and
equally important are our payments towards repayment of loans and its servicing. When demand outplays supply, it is only prudent that we manage our foreign exchange reserves judiciously.

Hence Reserve Bank of India, under the provisions of Foreign Exchange Regulation Act 1973, controls the inflow and outflow of foreign exchange. Through the Exchange Control Manual (1993 Edition) and subsequent AD (MA) Circulars, it enforces the proper management of country's foreign exchange.

**TRADE CONTROL:**

It is equally important for any country to effectively monitor the movement of goods. While the movement of foreign exchange is being controlled through Exchange Control Manual and subsequent AD (MA) circulars, goods movement in and out of the country is being monitored under the provisions of Foreign Trade (Development and Regulations) Act, 1992. The controlling authority in this case is Director General of Foreign Trade, New Delhi, and their various offices in other places headed by Joint Director of Foreign Trade. D.G.F.T. and J.D.F.T. are guided by the FT POLICY (02-07), which is being provided by the Ministry of Commerce, Government of India. Customs are the authorities who are ensuring the movement of goods according to the above-said provisions, besides collection of revenues by way of duty on goods imported or exported.

**HOW THE FOREIGN EXCHANGE IS HANDLED?**

Reserve Bank of India under the provisions of FEMA, has delegated the authority of handling Foreign Exchange to State Bank of India (and its subsidiaries), Public Sector Banks, Private Sector Banks and Foreign Banks. They have delegated the authority of handling Foreign Exchange and they are explained through various Chapters of Exchange Control Manual, a book released by RBI, the latest one being 1993 edition. Under ECM, designated Authorised Dealers (of Foreign Exchange) will be dealing in various Foreign Exchange transactions, to comply with all terms and conditions. Again Banks that are authorised to handle Foreign Exchange, designate certain branches to handle the Foreign Exchange transactions, depending the necessity and potentiality of branch's location and they are called Authorised dealing branches.

Besides the above, RBI also authorises reputed Hotels and other private establishments to handle Foreign Exchange in a limited way (say they can issue / encash Foreign Currency Travellers' Cheques / Foreign Currency Notes) to cater to the foreign tourists' requirements. They are called Authorised Money Changers (AMC). They are classified as FULLFLEDGED / RESTRICTED MONEYCHANGERS.

**TYPES OF FOREIGN EXCHANGE TRANSACTIONS:**

Authorised Dealers can handle two types of transactions, viz. Purchase and Sale of Foreign Exchange. When customers tender export bills denominated in Foreign Currency, ADs shall purchase the Foreign Currency Bill. Likewise, when customers request for a remittance in Foreign Currency towards payment of Import bills, then ADs have to sell Foreign Currency to him. From this, we understand that both selling and purchasing transactions are from the bank's angle.

**SETTLEMENT OF FOREIGN EXCHANGE TRANSACTIONS:**

Settlements of Foreign Exchange Transactions are made through the following accounts:-

1. **NOSTRO Account:** Our Account with you;

   Ex: The account maintained by an Authorised Dealer with a foreign bank is called "NOSTRO" Account or "Our Account with You". When an instrument like a cheque or an export bill is purchased the same is sent to the overseas bank (correspondent) for realisation, the amount is collected and credited to Authorised Dealer's account with them.

   Similarly, when a draft is issued on a banks foreign correspondent it will be paid at the overseas centre by debiting the NOSTRO Account of the issuing bank.

2. **VOSTRO Account:** Your Account with us
Ex.: Foreign banks (Correspondents) also maintain accounts with any bank in India in Indian Rupees for the purpose of settling their rupee transactions and these accounts

3. LORO Account: Their account with them

Ex.: Just like State bank Of India maintaining an account with foreign correspondent say BTC, New York, Canara Bank may also maintain a Nostro Account with them. When SBI advises BTC New York for transfer of funds to Canara Bank Account with them, Canara Bank Account is titled as Loro Account “i.e. their account with you”.

When our bank deals in an export credit bill on collection basis/on realisation of export bills negotiated /purchased/discounted, the foreign currency funds is to be credited to our account. For this purpose, we maintain Foreign Currency accounts with our various correspondents abroad. The account is called NOSTRO account. Once the proceeds are credited in our NOSTRO account, we receive the statement, based on which, the concerned branch, who have handled the transaction, will be informed.

Likewise, when we would like to make remittances, on behalf of our customers towards import payments, miscellaneous remittances, etc., we give instructions to our correspondents, to debit our NOSTRO account and effect payment.

Sometimes our correspondents maintain VOSTRO accounts (Rupee accounts of Nonresident banks) with our bank and payment or receipts are made through this account. For exports, they will authorise us to debit their VOSTRO account and for imports, they will give instructions to credit their account.

Likewise whenever the account of one bank in the books of the same correspondent, where we are maintaining our NOSTRO account, the other bank’s account with the correspondent is referred as LORO account. That is the account maintained by Indian Bank with our correspondent Bankers Trust Co Newyork, will be referred as LORO account of Indian Bank.

EXCHANGE RATES:

The rate, at which a currency is converted into another currency, is called the rate of exchange. Such rates are arrived from the base rate, which is decided by market forces and is quoted on a daily basis. Banks quote various rates for different types of operations like Bill buying, Bill selling, TT (DD/MT/TT) buying, TT (DD/MT/TT) selling, etc. The rates are arrived after loading suitable margins, as per F.E.D.A.I. (Foreign Exchange Dealers Association of India) guidelines.

FOREIGN EXCHANGE MARKET:

Foreign Exchange Market is an Over the Counter Market. It means that there is no fixed market place. Market players are differently and distantly located. It has no borders and barriers. All the transactions are put through over telecommunications followed up by written confirmations. Hence there is the need of high level professionalism for the market players, which is in place.

Market Players are Authorised Dealers, Recognised Foreign Exchange brokers, Exporters, Importers, Reserve Bank of India. Sometimes market dealers include foreign banks abroad.

As such, Foreign Exchange Market is a three tier market viz.:  

Lowercase letters list:

b. Inter Bank Market : Between Authorised Dealers in India including Reserve Bank.
c. INTERNATIONAL MARKET : Comprising all Banks who deal in Foreign Exchange at select international Foreign Exchange Centres like Singapore, Hong Kong, Tokyo, London, New York, etc. When an Authorised Dealer is unable to cover a deal in the local market, he will approach the other Bankers in the International Market for covering his deal.

Foreign Exchange is a scarce commodity, Hence, it is subject to control.

It commands a price due to the forces of supply and demand.

It has an active market (both domestic and international).

Authorised Dealers maintain stocks of Foreign Exchange abroad to meet contingencies in the form of balances in Nostro Accounts with their Correspondent Banks.
F.E.D.A.I.

It is an association of all the AD banks in India to liaise with each other, with RBI and other agencies. They prescribe the rules and charges for various foreign exchange transactions, with the concurrence of all the members.