

# Example by StudyDriver

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## Forex Market Example

### Acknowledgement

I would like to express my profound sense of gratitude to the Dean of International Institute of Planning and Management, Mr. Pabitra Chakravorthy, who has given me a golden opportunity to make thesis on “Five Key Factors That Moves the Forex Market” I am very thankful to Prof. Tarak Shah, Faculty guide of my thesis, for giving me an opportunity & guidance throughout the thesis. The words are insufficient to say thanks to Mr. Paresh Shah for his unconditional & wonderful support for successful completion of our project. I am also very thankful to Mr. Darshan Soni of Darshan Forex and Mr. Girish Shah & Bharat Mehta of Shah & Shah Investors. They have guided us throughout the thesis. They have solved my each & every query & provide me good knowledge regarding how the forex derivative works practically.

### Preface

Just as stranger walk on path & last arrive at their destination; project work is like a path after walking in which students can gain experience & knowledge that can be stepping stone towards their success. It is such a work that

enhances each & every individual working capacity & knowledge. The Importance of Thesis is that it is blending of both theoretical & practical knowledge. Through the thesis, I got a golden chance to have guidance under professionals & senior executives which can definitely be a platform of establishing themselves. During my thesis work I visited AMA Library, Gujarat Chamber of Commerce and SBI which helped us a lot to gain information about Forex derivatives. This opportunity of thesis provided to me was not only a platform to develop & enhance my appetite of learning but also served a fusion of the theoretical concept & their practical application in corporate world.

## **INTRODUCTION:**

To make a profit from the forex market of International trade you have a grip on mainly five key factors that affects a currency value. When making our trades we analyze five key factors which are as follows. · Interest Rates · Economic Growth · Geo-Politics · Trade and Capital Flows · Merger and Acquisition Activity

### **Interest Rates:**

Interest income and capital appreciation these two methods we can use to make profit from different in terms of countries' interest rates.

### **Interest Income.**

Every currency in the world comes attached with an interest rate that is set by its country's central bank. All things being equal, you should always \* Buy currencies from countries with high-interest rates and \* Finance these purchases with currency from countries with low-interest rates. For example, as of the fall of 2006, interest rates in the United States stood at 5.25%, while rates in Japan were set at .25%. You could have taken advantage of this rate difference by borrowing a large sum of Japanese yen, exchanging it for US dollars and using the US dollars to purchase bonds or cds at the US 5.25% rate. In other words, you could have borrowed money at .25%, lent it out at 5.25%, and made a 5% return. Or you could save yourself all the hassle of becoming a money lender by simply

trading the currency pair to affect the same transaction.

## **Capital appreciation.**

As a country's interest rate rises, the value of the country's currency also tends to rise-- this phenomenon gives you a chance to profit from your currency's increased value, or capital appreciation. In the case of the USD/JPY spread in 2005 and 2006, as the US interest rates stayed higher than Japan's, the dollar continued to increase in value. Investors who traded yen for dollars gained from interest income as well as the US dollar's capital appreciation.

## **Economic Growth.**

Economic Growth is next factor when predicting a country's currency movements. The stronger the economy, the greater the possibility that the central bank will raise its interest rates in order to the growth of inflation. And the higher a country's interest rates, the bigger the likelihood those foreign investors will invest in a country's financial markets. More foreign investors mean a greater demand for the country's currency. A greater demand results in an increase in a currency's value. Hence economic growth inspires higher interest rates inspires more foreign investment inspires greater currency demand which inspires an increase in the currency's value.

## **Geo-Politics.**

The currency market is the only market in the world that can be successfully traded on political news as well as economic releases. Because currencies represent countries rather than companies and any disturbance to the political landscape will oftentimes affect the direction in which the exchange rate moves. The key to understanding speculative behavior with respect to any geopolitical unrest is that speculators run first and ask questions later. In other words, whenever investors fear any threat to their capital, they will quickly retreat to the sidelines until they are certain that the political risk has disappeared. Therefore, the general rule of thumb in the currency market is that politics almost always trumps economics.

## Trade and Capital Flows

Before ever making a final prediction regarding the movement (or trend) of a particular currency you should determine whether or not the currency is dependent on its country's capital or trade flow. Capital flow refers to the amount of investment a country receives from international sources. Trade flow is the income resulting from trade. Some countries can be very dependent their capital flow, while other countries are extremely sensitive to trade flows.

## Mergers and Acquisitions

Merger and acquisition activity is the least important factor in determining the long-term direction of currencies. It can be the most powerful force in staging near-term currency moves. Merger and acquisition activity occurs when a company from one economic region wants to make a transnational transaction and buy a corporation from another country. For example, a European company wants to buy a Canadian asset for \$20 billion, it would have to go into the currency market and acquire the currency to affect this transaction. Typically, these deals are not price sensitive, but time sensitive because the acquirer may have a date by which the transaction is to be completed. Because of this underlying dynamic, merger and acquisition flow can exert a very strong temporary force on FX trading, sometimes skewing the natural course of currency flow for days or weeks.

## OBJECTIVE:

Main Objective is for getting in depth knowledge of my topic.

1. To critically analyze the Forex market of International trade.
2. To analyze the five key factors that moves the Forex market and how to make profit out of them.
3. To analyze the present data and forecasting a future movement of Forex market.

## **METHODOLOGY:**

1. Introduction of the topic in detail.
2. For predict market movement I am using two methods like fundamental analysis and technical analysis.  
Technical analysis includes Candlestick Charts and Moving Averages (Simple and Exponential)

## **SOURCES:**

### **Primary source**

Taking interview of the expertise in the Forex market.

### **Secondary source**

Use Books, Magazines, Newspapers, Research papers and Internet as secondary sources

## **LIMITATIONS:**

1. I have to follow only these five factors for move the Forex market.
2. Interview is the only primary research in the Forex market.
3. Inflation is the main factor which moves the Forex market but which is not included in the five factors.
4. Merger and Acquisition is the least important factor.

## **CHAPTER 1:**

## INTRODUCTION OF FOREIGN EXCHANGE

Foreign Exchange is the method or process of conversion/converting one currency into another currency. Currency becomes money and legal tender for a country. But for a foreign country it becomes the value as a commodity. Since the commodity has a value its relation with the other currency determines the exchange value of one currency with the other. It is just the game of supply and demand. For example, the US dollar in USA is the currency in USA but for India it is just like a commodity which has a value which varies according to demand and supply. Foreign exchange is one of the economic activity which deals with the means and methods by which rights to wealth expressed in terms of the currency of one country are converted into rights to wealth in terms of the current of another country. It involves the investigation of the method which exchanges the currency of one country for that of another. Foreign exchange can also be defined as the means of payment in which currencies are converted into each other and by which international transfers are made also the activity of transacting business in further means.

Most countries of the world have their own currencies. The US has its dollar, France its franc, Brazil its cruziero and India has its Rupee. Trade between the countries involves the exchange of different currencies. The foreign exchange market is the market in which currencies are bought and sold against each other. It is the largest market in the world. Transactions conducted in foreign exchange markets determine the rates at which currencies are exchanged for one another, which in turn determine the cost of purchasing foreign goods & financial assets. The most recent, bank of international settlement survey stated that over \$900 billion were traded worldwide each day. During peak volume period, the figure can reach upward of US \$2 trillion per day. The corresponding to 160 times the daily volume of NYSE.

## CHAPTER 2:

## ORIGIN OF THE FOREX MARKET

The FOREX trading traces its history to centuries ago. Different currencies and the need of exchange them had existed since the Babylonians. They are credited with the first use of paper notes and receipts. In that time the value of goods were expressed in terms of other goods which were called as Barter system. The obvious limitations of such a system encouraged establishing more generally accepted mediums of exchange. It was important that a common base of value could be established. In some economies, items such as teeth, feathers even stones served this purpose, but soon various metals, in particular gold and silver, established themselves as an accepted means of payment as well as a reliable storage of value.

Trade was carried among people of Africa, Asia etc through this system. Coins were initially minted from the preferred metal and in stable political regimes, the introduction of a paper form of governmental I.O.U. during the middle Ages also gained acceptance. This type of I.O.U. was introduced more successfully through force than through persuasion and is now the basis of today's modern currencies. Before the First World War, most Central banks supported their currencies with convertibility to gold. However, the gold exchange standard had its weaknesses of boom-bust patterns. As an economy strengthened, it would import a great deal from out of the country until it ran down its gold reserves required to support its money. As a result, the money supply would diminish, interest rates escalate and economic activity slowed to the point of recession. Ultimately, prices of commodities had hit bottom and it appearing attractive to other nations who would sprint into buying fury that injected the economy with gold until it increased its money supply, drive down interest rates and restore wealth into the economy.

However, for this type of gold exchange, there was not necessarily a Central bank need for full coverage of the government's currency reserves. This did not occur very often, however when a group mindset fostered this disastrous notion of converting back to gold in mass, panic resulted in so-called "Run on banks". The combination of a greater supply of paper money without the gold to cover led to devastating inflation and resulting political instability. The Great Depression and the removal of the gold standard in 1931 created a serious lull in FOREX

market activity. From 1931 until 1973, the FOREX market went through a series of changes. These changes greatly affected the global economies at the time and speculation in the FOREX markets during these times was little. In order to protect local national interests, increased foreign exchange controls were introduced to prevent market forces from punishing monetary irresponsibility. Near the end of World War II, the Bretton Woods agreement was reached on the initiative of the USA in July 1944. The c

onference held in Bretton Woods, New Hampshire rejected John Maynard Keynes suggestion for a new world reserve currency in favor of a system built on the US Dollar.

International institutions such as the IMF, The World Bank and GATT were created in the same period as the emerging victors of WWII searched for a way to avoid the destabilizing monetary crises leading to the war. The Bretton Woods agreement resulted in a system of fixed exchange rates that reinstated The Gold Standard partly, fixing the USD at \$35.00 per ounce of Gold and fixing the other main currencies to the dollar, initially intended to be on a permanent basis. The Bretton Woods system came under increasing pressure as national economies moved in different directions during the 1960's. A number of realignments held the system alive for a long time but eventually Bretton Woods collapsed in the early 1970's following president Nixon's suspension of the gold convertibility in August 1971. The dollar was not any longer suited as the sole international currency at a time when it was under severe pressure from increasing US budget and trade deficits. The last few decades have seen foreign exchange trading develop into the world's largest global market. Restrictions on capital flows have been removed in most countries, leaving the market forces free to adjust foreign exchange rates according to their perceived values. The European Economic Community introduced a new system of fixed exchange rates in 1979, the European Monetary System.

The quest continued in Europe for currency stability with the 1991 signing of The Maastricht treaty. This was to not only fix exchange rates but also actually replace many of them with the Euro in 2002. London was, and remains the principal offshore market. In the 1980s, it became the key center in the Eurodollar market when British banks began lending dollars as an alternative to pounds in order to maintain their leading position in



global finance. In Asia, the lack of sustainability of fixed foreign exchange rates has gained new relevance with the events in South East Asia in the latter part of 1997, where currency after currency was devalued against the US dollar, leaving other fixed exchange rates in particular in South America also looking very vulnerable. While commercial companies have had to face a much more volatile currency environment in recent years, investors and financial institutions have discovered a new playground. The FOREX exchange market initially worked under the central banks and the governmental institutions but later on it accommodated the various institutions. At present it also includes the dot com booms and the World Wide Web. The size of the FOREX market now dwarfs any other investment market. The foreign exchange market is the largest financial market in the world. Approximately 1.9 trillion dollars are traded daily in the foreign exchange market. It is estimated that more than USD 1,200 Billion are traded every day. It can be said easily that FOREX market is a lucrative opportunity for the modern day savvy investor

## **SHORT INFO OF FOREX**

The history of FOREX trading was traced centuries ago. Different countries need different currencies and the need of exchange them had existed since the Babylonians. It is said that Babylonians were the first one who used paper notes and receipts. During those days, goods were exchanged for another goods based on the value of both the goods, which was known as barter system. But this system had some limitations and this lead to encourage establishing more generally accepted medium of exchange. It was also important that a common base of value could be established. In some economies, items such as teeth, feathers even stones served this purpose, but soon various metals, in particular gold and silver, established themselves as an accepted means of payment as well as a reliable storage of value. Trade was carried among people of Africa, Asia etc through this system. Coins were initially minted from the preferred metal and in stable political regimes, the introduction of a paper form of governmental I.O.U. during the middle Ages also gained acceptance. This type of I.O.U. was introduced more successfully through force than through persuasion and is now the basis of today's modern currencies. Before the First World War, most Central banks supported their currencies with convertibility to gold. However, the gold exchange standard had its weaknesses of boom-bust patterns.

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## **CHAPTER 3:**

### **METHODS OF QUOTING EXCHANGE RATES**

There are two methods of quoting exchange rates.

## **Direct method:**

For change in exchange rate if foreign currency is kept constant and home currency is kept variable, then the rates are stated be expressed in 'Direct Method' E.g. US \$1 = Rs. 45.50.

## **Indirect method:**

For change in exchange rate if home currency is kept constant and foreign currency is kept variable, then the rates are stated be expressed in 'Indirect Method'. E.g. Rs. 100 = US \$ 2.5116 With the effect from August 2, 1993, all the exchange rates are quoted in direct method, i.e. US \$1 = Rs. 45.50 GBP1 = Rs. 79.82

## **Method of Quotation**

In the Forex market there are two rates like one is for buying and one is for selling rates. This helps in eliminating the risk of being given bad rates i.e. if a party comes to know what the other party intends to do i.e., buy or sell, the former can take the latter for a ride. There are two parties in an exchange deal of currencies. To begin the deal one party asks for quote from another party and the other party quotes a rate. The party asking for a quote is known as 'Asking party' and the party giving quote is known as 'Quoting party'

## **The advantages of two way quote.**

1. It automatically ensures alignment of rates with market rates.
2. The market constantly makes available price for buyers and sellers.
3. Two-way price limits the profit margin of the quoting bank and comparison of one quote with another quote can be done immediately.
4. It is not necessary for any player in the market to show whether he intends to buy or sell foreign currency but this ensures that the quoting bank cannot take advantage by manipulating the prices.
5. Two-way quotes lend depth and liquidity to the market and which is very essential for efficient.

6. In two-way quotes for the first rate is the rate for buying and another rate is for selling. We should understand here that in India the banks which are authorized dealers, always quote rates. So the rates quote - buying and selling is for banks will buy the dollars from him so while calculation the first rate will be used which is a buying rate, as the bank is buying the dollars from the exporter.
7. The same case will happen inversely with the importer, as he will buy the dollars from the banks and bank will sell dollars to importer.

## **BASE CURRENCY**

Even if a foreign currency can be bought and sold in the same way as a commodity but they're use as a minor difference in buying/selling of currency aid commodities. Unlike in case of commodities, in case of foreign currencies two currencies are involved so, it is necessary to know which the currency to be bought and sold is and the same one is known as 'Base Currency'.

## **BID &OFFER RATES**

The buying and selling rates are also referred to as the bid and offered rates. In the dollar exchange rates referred to above, namely, \$ 1.6288/96, the quoting bank is offering (selling) dollars at \$ 1.6288 per pound while bidding for them (buying) at \$ 1.6296. So in this quotation the bid rate for dollars is \$ 1.6296 while the offered rate is \$ 1.6288. The bid rate for one currency is automatically the offered rate for the other. In the above example, the bid rate for dollars \$ 1.6296, is also the offered rate of pounds.

## **CROSS RATE CALCULATION**

US Dollar is the most trading currency in the forex market. In other words one support of most exchange trades is the US currency so margins between bid and offered rates are lowest quotations if the US dollar. The margins tend to widen for cross rates, as the following calculation would show. Consider the following structure: GBP 1.00 = USD 1.6288/96 EUR 1.00 = USD 1.1276/80 In this rate structure, we have to calculate the bid and offered rates

for the euro in terms of pounds. Let us see how the offered (selling) rate for euro can be calculated. Starting with the pound, you will have to buy US dollars at the offered rate of USD 1.6288 and buy Euros against the dollar at the offered rate for euro at USD 1.1280. The offered rate for the euro in terms of GBP, therefore, becomes EUR  $(1.6288 \times 1.1280)$ , i.e. EUR 1.4441 per GBP, or more conventionally, GBP 0.6925 per euro. Similarly, the bid rate the euro can be seen to be EUR 1.4454 per GBP (or GBP 0.6918 per euro). Thus, the quotation becomes GBP 1.00 = EUR 1.4441/54. It will be eagerly noticed that in percentage terms the difference between the bid and offered rate is higher for the EUR: pound rate as compared to dollar: EUR or pound: dollar rates.

## **CHAPTER 4:**

### **ADVANTAGES OF FOREX MARKET**

The Forex market is by far the largest and most liquid in the world but also day traders have up to now focused on looking for profits in mainly stock and futures markets. This is mainly due to the restrictive nature of bank-offered forex trading services. There are Advanced Currency Markets (ACM) offers both online and traditional phone forex-trading services to the small investor with minimum account opening values starting at 5000 USD. There are many advantages to trading spot foreign exchange as opposed to trading stocks and futures. These are the some advantages as under.

#### **Commissions:**

ACM offers foreign exchange trading commission free. This is in sharp contrast to (once again) what stock and futures brokers offer. A stock trade can cost anywhere between USD 5 and 30 per trade with online brokers and typically up to USD 150 with full service brokers. Futures brokers can charge commissions anywhere between USD 10 and 30 on a round turn basis.

## **Margins requirements:**

ACM offers a foreign exchange trading with a 1% margin. In layman's terms that means a trader can control a position of a value of USD 1'000'000 with a mere USD 10'000 in his account. By comparison, futures margins are not only constantly changing but are also often quite sizeable. Stocks are generally traded on a non-margined basis and when they are, it can be as restrictive as 50% or so.

## **24 hour market:**

Foreign exchange market trading occurs over a 24 hour period picking up in Asia around 24:00 CET Sunday evening and coming to an end in the United States on Friday around 23:00 CET. Although ECNs (electronic communications networks) exist for stock markets and futures markets (like Globex) that supply after hours trading, liquidity is often low and prices offered can often be uncompetitive.

## **No Limit up / limit down:**

Futures markets contain certain constraints that limit the number and type of transactions a trader can make under certain price conditions. When the price of a certain currency rises or falls beyond a certain pre-determined daily level traders are restricted from initiating new positions and are limited only to liquidating existing positions if they so desire. The controlling of daily price volatility is the main mechanism but in effect since the futures currency market follows the spot market anyway the following day the futures market may undergo what is called a 'gap' or we can say also in other words the futures price will re-adjust to the spot price the next day. In the OTC market no such trading constraints exist permitting the trader to truly implement his trading strategy to the fullest extent. Since a trader can protect his position from large unexpected price movements with stop-loss orders the high volatility in the spot market can be fully controlled.

## **Sell before you buy:**

Equity brokers offer very restrictive short-selling margin requirements to customers. This means that a customer does not possess the liquidity to be able to sell stock before he buys it. When initiating a selling or buying position in the spot market a trader has exactly the same capacity in margin wise. In spot trading when you are selling one currency you are necessarily buying another.

## **CHAPTER 5:**

### **FOREX EXCHANGE RISK**

The Risk Management Guidelines are primarily an accent of some good and prudent practices in exposure management. They have to be understood and slowly internalized and customized so that they yield positive reimbursement to the company over time. Any business is open to risks from movements in competitors' prices, raw material prices, competitors' cost of capital, foreign exchange rates and interest rates, all of which need to be (ideally) managed.

### **Forex Risk**

Everywhere in the world risk is attached. Without risk there is no gain. Also the FOREX is not risk-free. Like if you are trading with substantial sums of money and there is always a possibility that trades will go against you. Also there are several trading tools so that can minimize your risk and with caution and above all education the FOREX trader can learn how to trade profitably and while minimizing losses.

### **Risks**

Assuming you are dealing with a reputable broker and there are still risks to FOREX trading. Transactions are subject to unexpected rate changes, volatile markets and political events.



## **Exchange Rate Risk:**

Exchange rate risk which refers to the fluctuations in the currency prices over a long trading period. The Prices can fall rapidly which are resulting in substantial losses unless and until stop loss orders are used when trading FOREX. And so stop loss orders specify that the open position should be closed if currency prices pass a predetermined level. Stop loss orders can be used in conjunction with limit orders to automate FOREX trading - limit orders specify an open position should be closed at a specified profit target.

## **Interest Rate Risk:**

It can result from discrepancies between the interest rates in the two countries which represented by the currency pair in a FOREX quote. This discrepancy can result in variations from the expected profit or loss of a particular FOREX transaction.

## **Credit Risk:**

It is the possibility that when the deal is closed one party in a FOREX transaction may not honor their debt and this may happen when a bank or financial institution declares insolvency. The Credit risk is minimized by dealing on regulated exchanges which require members to be monitored for credit worthiness.

## **Country Risk:**

Country risk is connected with governments that may become involved in foreign exchange markets by limiting the flow of currency. There is more country risk associated with exotic currencies than with major currencies that allow the free trading of their currency.

## Limiting Risk in your FOREX currency trading system

FOREX trading can be very risky but there are ways to limit your risk and financial exposure. Every FOREX trader should have a trading strategy for knowing when to enter and when to exit the market and what kind of movements to expect. Developing strategies requires education for the key to limiting FOREX risk. At all times follow the basic rule that do not place money in the FOREX that you cannot afford to lose. Every FOREX trader needs to know at least the basics about technical analysis and how to read financial charts. He should study chart movements and indicators and understand how charts are interpreted. Even the most knowledgeable traders however can't predict with absolute certainty how the market will behave. For this reason, every FOREX transaction should take advantage of available tools designed to minimize loss. Stop-loss orders are the most common ways of minimizing risk when placing an entry order. A stop-loss order contains instructions to exit your position if the currency price reaches a certain point. If you take a long position (expecting the price to rise) you would place a stop loss order below current market price. If you take a short position (expecting the price to fall) you would place a stop loss order above current market price. As an example, if you take a short position on USD/CDN it means you expect the US dollar to fall against the Canadian dollar. The quote is USD/CDN 1.2136/43 - you can sell US\$1 for 1.2136 CDN dollars or sell 1.2143 CDN dollars for US\$1.

### **You place an order like this:**

Sell USD:1 standard lot USD/CDN @ 1.2136 = \$121,360 CDNPip Value:1 pip = \$10 Stop-Loss:1.2146 Margin:\$1,000 (1%) You are selling US\$100,000 and buying CDN\$121,360. Your stop loss order will be executed if the dollar goes above 1.2146, in which case you will lose \$100. However, USD/CDN falls to 1.2116/23. You can now sell \$1 US for 1.2116 CDN or sell 1.2123 CDN for \$1 US. Because you entered the transaction by selling US dollars (buying short), you must now buy back US dollars and sell CDN dollars to realize your profit. You buy back US\$100,000 at the current USD/CDN rate of 1.2123 for a cost of 121,223 CDN. Since you originally sold them for CDN\$121,360 you made a profit of \$155 Canadian dollars or US\$127.85 (155 divided by the current exchange rate of 1.2123).

## CHAPTER 6:

### FOREIGN EXCHANGE EXPOSURE

Adler and Dumas defines the foreign exchange exposure as 'the sensitivity of changes in the real domestic currency value of assets and liabilities or operating income to unanticipated changes in exchange rate'. Foreign exchange risk is mainly related to the variability of the domestic currency values of assets, liabilities and operating income due to unanticipated changes in exchange rates. When there is a condition prevalent where the exchange rates become extremely volatile the exchange rate movements are destabilize the cash flows of a business significantly then such destabilization of cash flows that affects the profitability of the business. And this profitability of the business risk is from the foreign currency exposures. Foreign currency exposure and the attendant risk occur whenever a business has an income and expenditure or an asset and liability in a currency other than that of the balance-sheet currency. Indeed exposures can arise even for companies with no income, expenditure, asset or liability in a currency different from the balance-sheet currency. We can define exposure as the degree to which a company is affected by exchange rate changes but there are different types of exposure, which we must consider. In simple terms that exposure is the amount of assets and liabilities and operating income that is at risk from unexpected changes in exchange rates. There are two sorts of foreign exchange risks or exposures. The term exposure refers to the degree to which a company is affected by exchange rate changes. Following are the types of foreign exposure/risks.

1. Transaction Exposure
2. Translation Exposure
3. Economic Exposure
4. Operational Exposure

## TRANSACTION EXPOSURE

Transaction exposure is the exposure which occurs from foreign currency denominated transactions which an entity is committed to complete. It arises from the contractual, foreign currency and future cash flows. For example, if a firm has entered into a contract to sell televisions at a fixed price denominated in a foreign currency and the firm would be exposed to exchange rate movements till it receives the payment and converts the receipts into domestic currency. The exposure of a company in a particular currency is measured in net terms, i.e. after netting off potential cash inflows with outflows. Transaction exposure is intrinsic in all foreign currency denominated contractual obligations/transactions. This involves gain or loss arising out of the various types of transactions and that require settlement in a foreign currency. The transactions may relate to cross-border trade in terms of import or export of goods, domestic purchases and sales of goods and services of the foreign subsidiaries, the borrowing or lending in foreign currencies and the purchase of asset or takeover of the liability involving foreign currency.

The actual profit the firm earns or loss it suffers is known only at the time of settlement of these transactions. While it is true that transaction exposure is applicable to all these foreign transactions, it is usually employed in connection with foreign trade which is specific imports or exports on open account credit. It is worth mentioning that the firm's balance sheet already contains items reflecting transaction exposure; the notable items in this regard are debtors receivable in foreign currency, creditor's payable in foreign currency, foreign loans and foreign investments. Suppose that a company is exporting deutsche mark and while costing the transaction had reckoned on getting say Rs 22 per mark. By the time the exchange transaction materializes i.e. the export is affected and the mark sold for rupees the exchange rate moved to say Rs 18 per mark. The profitability of the export transaction can be completely wiped out by the movement in the exchange rate. Such transaction exposures arise whenever a business has foreign currency denominated receipt and payment. The risk is an adverse movement of the exchange rate from the time the transaction is budgeted till the time the exposure is extinguished by sale or purchase of the foreign currency against the domestic currency.

## TRANSLATION EXPOSURE

Translation exposure is the exposure which arises from the need to convert values of assets and liabilities denominated in a foreign currency into the domestic currency. Translation exposure means any exposure arising out of exchange rate movement and ensuing change in the domestic-currency value of the deposit would classify as translation exposure. It is potential for change in reported earnings and in the book value of the consolidated corporate equity accounts as a result of change in the foreign exchange rates. For any given period of time Translation exposure arises from the need to "translate" foreign currency assets or liabilities into the home currency. Translation exposure is for the purpose of finalizing the accounts. The treatment of foreign currency borrowings is a typical example of translation exposure and which consider that a company has borrowed dollars to finance the import of capital goods worth Rs 20000. When the import materialized the exchange rate was say Rs 30 per dollar. The imported fixed asset was therefore capitalized in the books of the company for Rs 600000.

In the ordinary course and assuming no change in the exchange rate the company would have provided depreciation on the asset valued at Rs 600000 for finalizing its accounts for the year in which the asset was purchased. If at the time of finalization of the accounts the exchange rate has moved to say Rs 35 per dollar, the dollar loan has to be translated involving translation loss of Rs50000. The book value of the asset thus becomes 650000 and consequently higher depreciation has to be provided thus reducing the net profit. Translation exposure relates to the change in accounting income and balance sheet statements caused by the changes in exchange rates and these changes may have taken place by/at the time of finalization of accounts vis-à-vis the time when the asset was purchased or liability was assumed.

We can say that in other words, translation exposure results from the need to translate foreign currency assets or liabilities into the local currency at the time of finalizing accounts. Alternatively, translation losses (or gains) may not be reflected in the income statement but they may be shown separately under the head of 'translation adjustment' in the balance sheet without affecting accounting income. This translation loss adjustment is to be carried out in the owners' equity account and the reason is that the accounting income has n

ot been diluted on account of translation losses or gains so it may be shown in the owner's equity account. On account of unstable ways of dealing with translation losses or gains, accounting practices vary in different countries and among business firms within a country. Whichever method is adopted to deal with translation losses/gains it is clear that they have a marked impact of both the income statement and the balance sheet.

## **ECONOMIC EXPOSURE**

An economic exposure is more a managerial concept than an accounting concept. A company can have an economic exposure to say Yen: Rupee rates even if company does not have any transaction or translation exposure in the Japanese currency. This would be the case for example, when the company's competitors are using Japanese imports. If the Yen weakens the company loses its competitiveness (vice-versa is also possible). Then the company's competitor uses the cheap imports and can have competitive edge over the company in terms of his cost cutting. Therefore an indirect way company exposed their Japanese yen. In simple words we can say that the economic exposure to an exchange rate is the risk that a change in the rate affects the company's competitive position in the market and so it indirectly affects the bottom-line. Economic exposure affects the profitability over a longer time than the transaction and even translation exposure. While translation and transaction exposures can be hedged the economic exposure cannot be hedged under the Indian exchange control.

Among all the exposures economic exposure is considered the most important because it has an impact on the valuation of a firm and it is defined as the change in the value of a company that accompanies an unanticipated change in exchange rates. It is important to note that anticipated changes in exchange rates are already reflected in the market value of the company. For example when an Indian firm transacts business with an American firm it has the expectation that the Indian rupee is likely to weaken vis-à-vis the US dollar and this weakening of the Indian rupee will not affect the market value (as it was anticipated, and hence already considered in valuation). So, in case the extent/margin of weakening is different from expected it will have a bearing on the market value. The market value may enhance if the Indian rupee depreciates less than expected. And also in case the Indian rupee

value weakens more than expected, it may entail erosion in the firm's market value. In brief, the unanticipated changes in exchange rates (favorable or unfavorable) are not accounted for in valuation and, hence, cause economic exposure. Economic exposure is not as precise and accurate as those of transaction and translation exposures but it involves subjectivity. Shapiro's definition of economic exposure provides the basis of its measurement. According to him, it is based on the extent to which the value of the firm—as measured by the present value of the expected future cash flows—will change when exchange rates change.

## **OPERATING EXPOSURE**

Operating exposure is a result of economic consequences (Cost). It is defined by Alan Shapiro as “the extent to which the value of a firm stands exposed to exchange rate movements, the firm's value being measured by the present value of its expected cash flows”. Economic exposure is known as of exchange rate movements on the value of a firm. Transaction and translation exposure cover the risk of the profits of the firm which being affected by a movement in exchange rates and on the other hand, operating exposure describes the risk of future cash flows of a firm changing due to a change in the exchange rate. Operating exposure has a longer-term perspective because Operating exposure has an impact on the firm's future operating revenues, future operating costs and future operating cash flows.. Given the fact that the firm is valued as a going concern entity and its future revenues and costs are likely to be affected by the exchange rate changes. In particular, it is true for all those business firms that deal in selling goods and services that are subject to foreign competition and/or uses inputs from abroad. In case, the firm succeeds in passing on the impact of higher input costs (caused due to appreciation of foreign currency) fully by increasing the selling price, it does not have any operating risk exposure as its operating future cash flows are likely to remain unaffected. The fewer prices elastic the demand of the goods/ services the firm deals in and the greater is the price flexibility it has to respond to exchange rate changes.

Price elasticity in turn depends on the degree of competition and location of the key competitors. The more differentiated a firm's products are the less competition it encounters and the greater is its ability to maintain its domestic currency prices both at home and abroad. Apart from supply and demand elasticities the firm's ability to

shift production and sourcing of inputs is another major factor affecting operating risk exposure. In operational terms, a firm having higher elasticity of substitution between home-country and foreign-country inputs or production is less susceptible to foreign exchange risk and so encounters low operating risk exposure. In short, the firm's ability to adjust its cost structure and raise the prices of its products and services is the major determinant of its operating risk exposure.

## **MANGING YOUR FOREIGN EXCHANGE RISK**

Once you know about the foreign exchange exposure will be and currencies involved then you can manage the risk and you will be in a position to consider. The options available to you fall into three categories:

### **1. DO NOTHING:**

This is a very high-risk and speculative strategy as you will never know the rate at which you will deal until the day and time the transaction takes place. You might choose not to actively manage your risk and which means dealing in the spot market whenever the cash flow requirement arises. Foreign exchange rates are disreputably volatile and movements make the difference between making a profit or a loss. If you are relying on buying or selling your currency in the spot market it is impossible to properly budget and plan your business.

### **2. TAKE OUT A FORWARD FOREIGN EXCHANGE CONTRACT:**

This will enable you to fix the exchange rate immediately to give you the certainty of knowing exactly how much that foreign currency will cost or how much you will receive at the time of settlement whenever this is due to occur. As soon as you know that a foreign exchange risk will occur and you could decide to book a forward foreign exchange contract with your bank. As a result you can budget with complete confidence. However, you will not be able to benefit if the exchange rate then moves in your favor as you will have entered into a binding contract which you are obliged to fulfill. You will also need to agree a credit facility with your bank for you to enter into this kind of transaction



### **3. USE CURRENCY OPTIONS:**

The method you decide to use to protect your business from foreign exchange risk will depend on what is right for you but you will probably decide to use a combination of all three methods to give you maximum protection and flexibility. A currency option will protect you against adverse exchange rate movements in the same way as a forward contract does but it will also allow the potential for gains should the market move in your favor. For this reason, a currency option is often described as a forward contract that you can rip up and walk away from if you don't need it. Many banks offer currency options which will give you protection and flexibility but this type of product will always involve a premium of some sort. The premium involved might be a cash amount or it could be factored into the pricing of the transaction. Finally, you may consider opening a Foreign Currency Account if you regularly trade in a particular currency and have both revenues and expenses in that currency as this will negate to need to exchange the currency in the first place.

## **CHAPTER 7**

### **FOREX TOOLS**

There are many tools available to the FOREX trader for analyzing the market as well as for buying and selling currencies. Software tools are a necessary part of FOREX because of its volume and volatility. In order to make lucid successful trades the FOREX trader needs information. Forex traders need more and more information. The trader needs historical data as well as current information about political and economic conditions that could affect currency prices. And all this information is provided by many FOREX brokers on their web sites. Political and economical condition is make accurate assessment from Forex traders. Being able to predict whether a currency will fall or rise against another currency allows the FOREX trader to profit from currency movements. For buying and selling currencies these are the two basic trading methods. Reactive trading means the trader responds to changes in the political or economic climate.

Speculative trading means the trader makes buying decisions and on based of these decisions predictions on how the market will respond to current events. While most FOREX trading is speculative both types of trade require up-to-time it means up-to-the-minute information and an analysis of current and historical conditions. Traders are relying on both fundamental and technical analyses. Fundamental analysis is based on news information about political conditions, economic policies, trade patterns, interest rates and unemployment rates and where Technical analysis relies on historical charting to identify trends and patterns over time. Information needed for both types of analyses is available in real time on the Internet. Most online brokers offer live news feeds and streaming rates for observing minute by minute changes in the market. All this information can help you decide which currencies to buy or sell. More tools are available in the market which to help you minimize your risk and maximize your profits.

### **TheRisk Probability Calculator (RPC):**

The RPC can be used to identify trades that who have more potential gain than potential loss. The RPC can also help you target exit points to end the trade.

### **Pivot Points:**

Pivot Point Calculators tell you whether prices fall in the normal trading range or extreme trading ranges. Pivot Points can be used for predict the movements of currency prices and they are calculated as an average of the currencies high, low and closing prices.

### **Pip Value Calculators:**

Pip calculators can tell you the actual profit or loss that will result from movements in the FOREX and also it is used to tell you the value of each pip (smallest currency unit) according to various sized lots. Once a trader has decided which currency pair to trade then he logs on his online account provided by his broker. After log on account the desired currency pair is entered and the current exchange rate appears on the screen. The amount of

the trade is entered (how much currency you wish to buy). Some brokers may give you the option of specifying the amount you wish to risk. This automatically enters a 'stop loss rate' into your order. After the details of the trade are entered you will be taken to a confirmation screen where you can accept the current price on screen. You may be given the option of 'freezing' the quoted price. Freezing means the price of your transaction is exactly what you see on screen without any slippage. Then accept the rate and your deal is running. If exchange rate falls below a certain rate just as you can enter a 'stop loss rate' to automatically sell the currency and then you can enter a 'take profit rate' to automatically sell the currency when it reaches a certain level. If you don't enter a 'take profit rate' you need to monitor the movement of the currency to decide when to close the deal and take either your profits or your losses.

## **CHAPTER 8**

### **FOREX ANALYSIS**

There are two types of analysis applied for analyzing and forecasting the movement of currency exchange rates.

1. Fundamental analysis 2. Technical analysis  
Fundamental Analysis Various indicators determine market moves in the FOREX trading. FOREX traders are always relying on analysis to make plan their trading strategies. There are two basic types of FOREX analysis - technical and fundamental. We can understand firstly fundamental analysis. Fundamental analysis refers to political and economic conditions that may affect currency prices. FOREX traders using fundamental analysis rely on news reports to gather information about unemployment rates, economic policies, inflation, and growth rates.

The aim of the fundamental analysis is to make middle-term and long-term predictions on the Forex market and it become necessary to conduct research on internal deep reasons for changes in currency exchange rates. Only this type of analysis will make it possible to estimate the prospects of dynamics of the currency demand and supply Most traders rely on technical analysis for plotting entry and exit points into the market and supplement their findings with fundamental analysis but Fundamental analysis is often used to get an overview of currency

movements and to provide a broad picture of economic conditions affecting a specific currency. Currency prices on the FOREX are affected by the forces of supply and demand, which in turn are affected by economic conditions. The two most important economic factors affecting supply and demand are interest rates and the strength of the economy. The strength of the economy is affected by the Gross Domestic Product (GDP), foreign investment and trade balance.

## **Indicators**

There are various indicators are released by government and academic sources. They are reliable measures of economic health and are followed by all sectors of the investment market. Indicators are usually released on a monthly basis but some are released weekly. Two of the most important fundamental indicators are interest rates and international trade. Other indicators include the Consumer Price Index (CPI), Durable Goods Orders, Producer Price Index (PPI), Purchasing Managers Index (PMI), and retail sales.

### **Interest Rates:**

Interest rate can have either a strengthening or weakening effect on a particular currency. The high interest rates attract foreign investment which will strengthen the local currency. On the other hand, stock market investors often react to interest rate increases by selling off their holdings in the belief that higher borrowing costs will adversely affect many companies. Stock investors may sell off their holdings causing a downturn in the stock market and the national economy. Determining which of these two effects will predominate depends on many complex factors, but there is usually a consensus amongst economic observers of how particular interest rate changes will affect the economy and the price of a currency.

### **International Trade:**

Trade balance which shows a deficit (more imports than exports) is usually an unfavorable indicator. Deficit trade balances means that money is flowing out of the country to purchase foreign-made goods and this may have a

devaluing effect on the currency. If a country habitually operates with a deficit trade balance this has already been factored into the price of its currency. Trade deficits will only affect currency prices when they are more than market expectations.

## **Other indicators include the CPI:**

Other indicators as CPI are a measurement of the cost of living and the PPI is a measurement of the cost of producing goods. The GDP measures the value of all goods and services within a country while the M2 Money Supply measures the total amount of all currency. There are 28 major indicators used in the United States. When preparing any strategies FOREX traders should be aware of them because Indicators have strong effects on financial markets. Up-to-date information is available on many websites and many FOREX brokers supply this information as part of their trading service.

## **Technical Analysis**

FOREX technical analysis are using historical economic data to predict movements and is critical for forex trading strategies FOREX analysis is divided into two types: Fundamental and Technical. Fundamental analysis attempts to predict movements in currencies by examining current political and economic events. Technical analysis uses historical economic data to predict movements in the FOREX. These two articles will examine the principles of technical analysis and the tools involved.

## **Basic Principles**

Technical analysis is based on three assumptions:

### **1. Market movement takes into account everything:**

Price movements are a result of all market forces combined. Things that can affect currency prices include

political events, economic conditions, supply and demand, seasonal variations and weather conditions. The technical analyst is not concerned with the reasons for market movement but more the movements themselves.

## **2. Prices have tends of movement:**

The main consequence of assumption that “prices move according to patterns” is that the current trend is most likely to continue its further development but not go into reverse. The trends are divided into the three types: Bullish trend - the price moves up Bearish trend - the price moves down Sideways trend- the price almost doesn't move. Currency prices follow trends. Many market patterns have been recognized as having predictable consequences.

## **3. The history repeats itself:**

These patterns are based on human psychology and the way people react to certain sets of circumstances. Price movements follow historical trends. FOREX data has been collected for over 100 years and patterns have emerged over time.

## **CHAPTER 9:**

### **FOREX CHARTS**

In FOREX technical analysis we will look at the various kinds of charts and provide basic guidelines for reading charts.

#### **Price Charts:**

Price Chartsshow information about FOREX prices at specified intervals of time. Intervals can be from one minute up to several years and everything in between. Prices can be plotted with simple line graphs or the price variation

for each interval can be shown by a bar or candlestick pattern. Price charts are usually supplemented with technical indicators. There are many Technical Indicators broadly divided into different categories which are Trend indicators, strength indicators, volatility indicators, and cycle indicators are just some of the analytical tools used to anticipate movement and market volume.

### **Line Charts:**

Line charts are very clean to read and make it easy to spot patterns, but they lack the detail of bar and candlestick charts. Line charts are suitable for getting a broad overview of price movements. They show the close price at the chosen intervals.

### **Bar Charts:**

Bar charts give much more information than line charts. The length of each bar indicates the price spread for the given period. A long bar indicates a large difference between high and low prices. The left tab on the bar shows the opening price and the right tab shows the closing price. Bar charts printed on paper (especially for short periods) can be difficult to read but software charts usually have a zoom function that makes it easier to read closely spaced bars.

### **Candlestick charts:**

Candlestick charts were invented by the Japanese for analyzing rice contracts. They are similar to bar charts in that they indicate open, close, high and low prices for a given period. They are easier to read than bar charts. It is easier to read because of their color coding. Green candlesticks show rising prices and red candlesticks show falling prices. Candlestick shapes- when viewed in relationship to neighboring candlesticks which provide indicators of market movement that can aid in chart analysis. Various shapes of candlesticks are formed according to price spread and the nearness of opening to closing prices. Candlestick patterns have been given fantastic names like 'morning star' and 'dark cloud cover' and once the shapes have been learned they are easy to

pick out on a chart for identifying trends in the market. Some of the most common technical indicators used in FOREX are: Average Directional Movement Index (ADX)- is used to determine if a market is entering a trend (either downward or upward) and how strong the trend is. Readings over 25 indicate a trend with higher values indicating stronger trends.

Moving Average Convergence/Divergence (MACD)- shows the momentum of the market and the relationship between two moving averages. When the MACD line crosses the signal line it indicates a strong market. Stochastic Oscillator- indicates the strength or weakness of a market by comparing a closing price to a price range over a period of time. When the stochastic is above 80 it indicates the currency is overbought while a stochastic below 20 indicates the currency is oversold. Relative Strength Indicator (RSI)- is a scale of 100 indicating the highest and lowest prices over a given period. When the price rises above 70 it is considered overbought and when the price falls below 30 it is considered oversold. Moving Average- is the average price for a given time interval when compared with other prices during similar time periods. For example, the closing prices over a 3 day period would have a moving average of the total of the 3 closing prices divided by 3. Bollinger Bands- are bands which contain the majority of a currency's price. The bands are three lines - the upper and lower lines following the price movement and the middle line showing the average price. During times of high volatility the distance between the upper and lower bands widen. If a bar or candlestick touches one of the bands it indicates overbought or oversold conditions.

## **CHAPTER 10:**

Factors which moves the forex market

### **Interest Rates:**

Interest income and capital appreciation are the two methods we can use to make profit from countries' interest rates.



## **Interest Income.**

Every currency in the world somehow attached with an interest rate which is set by its country's central bank. All things are same you should always \* Buy currencies from countries with high-interest rates and \* Finance these purchases with currency from countries with low-interest rates.

## **Economic Growth.**

Economic Growth is next factor when predicting a country's currency movements. The stronger the economy means the greater will be the possibility of that the central bank will raise its interest rates in order to the growth of inflation. And the higher a country's interest rates means the bigger the likelihood those foreign investors will invest in a country's financial markets. More foreign investors mean a greater demand for the country's currency. A greater demand results in an increase in a currency's value. Hence economic growth inspires higher interest rates and it inspires more foreign investment. More foreign investment inspires greater currency demand and last which inspires an increase in the currency's value.

## **Geo-Politics.**

Geo-political is the important factor which moves Forex market and the currency market is the only market which successfully traded on political news as well as economic releases in the world. Because currencies represent countries rather than companies and any disturbance to the political landscape will oftentimes affect the direction in which the exchange rate moves. The key understanding of speculative behavior with respect to any geopolitical factor that speculators run first and ask questions later. In other words whenever investors fear any threat to their capital they will quickly retreat to the sidelines until they are certain that the political risk has disappeared. Therefore the general rule of thumb in the currency market is that politics almost always trumps economics.

## Trade and Capital Flows

You should always determine whether or not the currency is dependent on its country's capital or trade flow before ever making a final prediction regarding the movement (or trend) of a particular currency. Capital flow refers to the amount of investment a country receives from international sources and Trade flow is the income resulting from trade. Some countries can be very dependent their capital flow and while other countries are extremely sensitive to trade flows.

## Mergers and Acquisitions

Merger and acquisition activity is the least important factor in determining the long-term direction of currencies. It can be the most powerful force in staging near-term currency moves. Merger and acquisition activity occurs when a company from one economic region wants to make a transnational transaction and buy a corporation from another country. For example, a European company wants to buy a Canadian asset for \$30 billion it would have to go into the currency market and acquire the currency to affect this transaction. Typically, these deals are not price sensitive but time sensitive because the acquirer may have a date by which the transaction is to be completed. Because of this underlying dynamic, merger and acquisition flow can exert a very strong temporary force on FX trading, sometimes skewing the natural course of currency flow for days or weeks.

## DIFFERENTIAL IN INFLATION:

As its purchasing power increases relative to other currencies a country with a consistently lower inflation rate exhibits a rising currency value. Different countries have different inflation rate which reflect the most. The countries with low inflation included Japan, Germany and Switzerland, while the U.S. and Canada achieved low inflation only later. Those countries with higher inflation typically see depreciation in their currency in relation to the currencies of their trading partners. This is also usually accompanied by higher interest rates.

## **CURRENT ACCOUNT DEFICITS:**

The current account is the balance of trade between a country and its trading partners which reflects all payments between countries for goods, services, interest and dividends. A deficit in the current account shows the country is spending more on foreign trade than it is earning and that it is borrowing capital from foreign sources to make up the deficit. In other words we can say that the country requires more foreign currency than it receives through sales of exports and supplies more of its own currency than foreigners demand for its products. The more demand for foreign currency so lowers the country's exchange rate until domestic goods and services are cheap enough for foreigners and foreign assets are too expensive to generate sales for domestic interests.

## **PUBLIC DEBT:**

Countries will engage in large-scale deficit financing. Deficit financing is paying for public sector projects and governmental funding. While such activity stimulates the domestic economy, nations with large public deficits and debts are less attractive to foreign investors. Reason for these is a large debt encourages inflation and if inflation is high the debt will be serviced and ultimately paid off with cheaper real dollars in the future. In the worst case scenario a government may print money to pay part of a large debt but increasing the money supply unavoidably causes inflation. Moreover, if a government is not able to service its deficit through domestic means (selling domestic bonds, increasing the money supply) then it must increase the supply of securities for sale to foreigners in that way lowering their prices. Finally, a large debt may prove worrisome to foreigners if they believe the country risks failure to pay on its obligations. Foreigners will be less willing to own securities denominated in that currency if the risk of default is great. For this reason, the country's debt rating is a crucial determinant of its exchange rate.

## **TERMS OF TRADE:**

A ratio comparing export prices to import prices is the terms of trade which related to current accounts and

the balance of payments. If the price of a country's exports rises by a greater rate than that of its imports its terms of trade have positively superior and increasing terms of trade shows bigger demand for the country's exports. This will show result in rising revenues from exports and which provides increased demand for the country's currency. If the price of exports rises by a smaller rate than that of its imports and the currency's value will decrease in relation to its trading partners.

## **POLITICAL STABILITY AND ECONOMIC PERFORMANCE:**

Foreign investors unavoidably look for out stable countries with strong economic performance in which to invest their capital. A country with such positive attributes will draw investment funds away from other countries perceived to have more political and economic risk. Political turmoil is example which can cause a loss of confidence in a currency and a movement of capital to the currencies of more stable countries.

## **CHAPTER 11:**

Important five key Factors which moves the forex market

### **FACTOR 1: Interest Rates**

we can use two methods to profit from the difference in countries' interest rates: \* Interest Income \* Capital Appreciation

#### **Generating Interest Income.**

Every currency in the world comes close with an interest rate that is set by its country's central bank. All things being equal you should always buy currency with high interest rates from country and sell/finance these purchases currency from low-interest rates. For example, as of the fall of 2006, interest rates in the United States stood at 4.25%, while rates in Japan were set at .25%. You could have taken advantage of this rate difference by

borrowing a large sum of Japanese yen, exchanging it for US dollars, and using the US dollars to purchase bonds or CDs at the US 4.25% rate. In other words, you could have borrowed money at .25%, lent it out at 4.25%, and made a 4% return. Or you could save yourself all the hassle of becoming a money lender by simply trading the currency pair to affect the same transaction.

## **Generating income from capital appreciation.**

As a country's interest rate increases, the value of the country's currency also tends to increase-- this phenomenon gives you a chance to profit from your currency's increased value or capital appreciation. In the case of the USD/JPY spread in 2005 and 2006, as the US interest rates stayed higher than Japan's interest rates, the dollar continued to increase in value. Investors who traded yen for dollars gained from interest income as well as the US dollar's capital appreciation. A wide spread in currency values provides investors with a ripened opportunity to earn income through both interest income and capital appreciation. Between January 2005 and November 2006, as the spread between US and Japanese interest rates widened, so did the spread between the currency values. A wide spread in currency values provides investors with a ripe opportunity to earn income through both interest income and capital appreciation.

## **Interest rates spark a 700 point rally**

Another great example of the power of interest rates in the currency market occurred in August of 2006. At that time the Bank of England stunned the market by raising its short-term rates from 4.5% to 4.75%. Interest rates for Japan were still at a low .25%. The increase in England's interest rates widened the interest rate differential on the popular GBP/JPY cross from 425 basis points to 450 basis points. Investment money flowed into Great Britain as traders bought up pounds to take advantage of the new spread. As the demand for the GBP increased, the value of the GBP increased, and the spread between the currencies increased. These domino effects led to a 700-point rally in the GBP/JPY over the next three weeks. When the Bank of England raised short-term interest rates in August 2006, it led to a 700-point rally in the GBP/JPY over the next three weeks.

## 80 Points in Less than 24 Hours

The concept of interest rates can be used to trade currencies using both long and short-term perspectives. On a long-term basis we look for major themes. On a short-term basis we look for surprises in the news that shift the market's interest rate expectations. We were able to make two winning trades based on short-term interest rate flows in the Australian dollar/Japanese yen (AUD/JPY) currency pair on January 24, 2009. The trigger for our trade was the surprise drop in Australian consumer prices during the fourth quarter. The market was looking for hot inflation numbers but instead they received cold ones. Low inflation numbers meant the central bank of Australia was not likely to raise interest rates as expected. This news sent the Australian dollar tumbling hard against the Japanese yen, as traders speculated that the interest rate differential between the two currencies would no longer grow. The first trade we made on January 24 banked us 45 points. We took profit before the currency pair retraced and then sold it again when it showed further signs of weakness. The second January 24 trades produced an additional 35 points for a total of 80 points. Australian dollar vs. Japanese yen, January 24, 2007. By predicting the affect of unexpectedly low inflation on the Australian dollar, we made two winning trades on January 24. Combined, these trades netted us 80 points in one day

## FACTOR 2: Economic Growth

Economic growth is the other factor while predicting a country's currency movement. The stronger the economy, the greater the possibility that the central bank will raise its interest rates to tame the growth of inflation and the higher a country's interest rates, the bigger the likelihood that foreign investors will invest in a country's financial markets. More foreign investors mean a greater demand for the country's currency. A greater demand results in an increase in a currency's value. Hence, a ripple effect: economic growth inspires higher interest rates inspires more foreign investment inspires greater currency demand which inspires an increase in the currency's value.

## How weak Economic Growth Crashed EUR/USD 2,000 Points

For a good example of the impact of economic growth on the direction of currency rates is the EUR/USD from 2005 to 2006. Economic growth is best measured by a country's Gross Domestic Product, or GDP. The United States and Euro zone represent two of the most prosperous regions in the world with GDPs running at \$13 trillion and \$11 trillion respectively. In 2005 and 2006, the difference in growth rates between the two major economic powers was clearly reflected in currency movements. In 2005 the Euro zone lagged significantly behind the United States in economic growth, averaging an anemic 1.5% rate throughout the year while the US expanded at a healthy 3% rate. Consequently, investment capital flowed from Europe to the US and the EUR/USD dropped by nearly 2,000 basis points by the end of 2005. In 2006, however, Euro zone growth perked up while US growth began to slow. At the end of 2006, Euro zone GDP actually overtook US growth rates, causing the EUR/USD to rally. In 2005, The EUR/USD plummeted as Euro zone showed little economic growth compared to the US GDP. In 2006, as the EZ GDP rallied, so did the EUR/USD. We've used GDP's to forecast trends on several more Forex trades in the past. One great example is our November 14, 2006 United States dollar/ Japanese yen trade (USD/JPY).

### 67 Points in Four Hours

In the middle of November 2006, hurt by the reduction in its housing sector the US economic data began to deteriorate. Rumor had it that the US might lower interest rates in the first quarter of 2007, which would encourage foreign investors to look elsewhere. Meanwhile, the Japanese economy was buoyed by the feeble yen that made Japanese products affordable internationally and helped encourage double digit growth in exports. On November 14, 2006, the Japanese GDP printed at much better than expected 2% versus the 1% forecast. We decided to take advantage of the strength of the Japanese economic growth vs. the relatively weak economic outlook in the US so we went short USD/JPY at 117.82. As we hoped, that morning, in sharp contrast to Japan, US retail sales produced very weak numbers and the USD/JPY pair collapsed. We were able to collect 67 points on the trade in less than four hours. United States dollar vs. Japanese yen, November 14, 2006. The strong economic growth in Japan made the USD/JPY trade a success for us in November.

## **FACTOR 3: Geo-Politics**

Geo-political is the important factor which moves Forex market and the currency market is the only market which successfully traded on political news as well as economic releases in the world. Because currencies represent countries rather than companies and any disturbance to the political landscape will oftentimes affect the direction in which the exchange rate moves. The key understanding of speculative behavior with respect to any geopolitical factor that speculators run first and ask questions later. In other words whenever investors fear any threat to their capital they will quickly retreat to the sidelines until they are certain that the political risk has disappeared. Therefore the general rule of thumb in the currency market is that politics almost always trumps economics. The history of FX is besieged with examples of political trades. Let's take a look at some examples over the past few years.

### **No-Confidence Vote Depresses Loonie**

The end of May 2005 was not a happy moment for the Liberal Party government of Canada's Prime Minister, Paul Martin. Martin was facing the fight of his life as his party prepared for a no-confidence vote stemming from accusations of past Liberal Party corruption after having guided the country to its best economic performance in 30 years. Meanwhile, Canada's economy was becoming a star performer spurred by the massive rises in the price of oil. As the number one exporter of crude to the US, Canada was benefiting mightily from this new found wealth. Yet despite the great economic news, the Canadian dollar remained weak against the greenback as traders worried about the implications of the fall of the Liberals. On May 26, 2005, Martin's government survived the no-confidence vote and the Canadian dollar rallied, causing the USD/CAD to push 200 points in less than a week as the market once again focused on Canada's stellar economic fundamentals.

**\*The USD/CAD pair trades inversely.**

Despite strong economic performance, the Canadian dollar remained weak until Martin survived the no-



confidence vote and the Canadian political climate settled.

## **Bank of Japan Governor Fukui Responsible for Floundering Yen**

At the beginning of June 2006, Bank of Japan Governor Fukui revealed to the Diet that he had invested 10 million yen in 1999 in a fund founded by financier Yoshiaki Murakami. Murakami was later indicted on charges of insider trading and although Fukui was not involved in any illegal activity and the mere appearance of impropriety in image-conscious Japan greatly damaged his reputation. As the principal of Japan's monetary policy during its recovery from a decade-long battle with deflation, Fukui was considered one of the most powerful men in the currency markets. His forced resignation would do great damage to the prospects of further recovery in Japan. Meanwhile, Japanese economic data continued to show stellar economic performance as exports and business investment continued to grow, unemployment reached decade-long lows, and consumer sentiment improved. Talk spread through the markets that Japan would soon abandon its zero-interest rate policy and would actually have positive interest rates for the first time this century. Despite all the positive speculation the yen floundered, continuing to decline against the dollar as traders feared that Fukui would have to step down.

Fukui stolidly refused, and as the furor passed and the market realized that he would stay on, the yen's strength returned, showing once again that when it comes to currencies, politics can often be more important than economics. Despite positive speculation and strong economic reports, the Japanese yen did not regain strength until investors realized that Fukui would not resign. If you enjoy predicting changes to the political landscape, your talents could be well utilized as a Forex trader. Recently, we predicted a strengthening of the Canadian dollar and earned close to 70 points in less than 24 hours. At 10 to 1 leverage you could have profited along with us, making a 7% return or \$700 on a \$10,000 trade.

## **How OPEC Made Us 70 Points**

Geopolitical risk means wars, terrorist attacks or missile launches, but it can also relate to milder yet still politically dominant events such as G7 meetings and OPEC announcements. In October 2006, Saudi Arabia announced that

they would back OPEC's plans to cut oil production by one million barrels a day after oil prices dropped more than 10% in just seven trading days. The cuts were to take effect on November 1, 2006, with more to come in December. As Canada is a major exporter and producer of oil, we believed that this policy change would be very positive for the Canadian dollar. Therefore we went short the US dollar and long the Canadian on October 19, 2006. Over the next 24 hours, based upon the geopolitical theme, we earned close to 70 points on the trade. United States dollar vs. Canadian dollar, October 19, 2006. Knowing that OPEC's announcement would affect Canadian currency allowed us to gain 70 points on October 19.

#### **FACTOR 4: Trade and Capital Flows**

Before you make your final prediction about the trend of a country's currency, you should take a moment to categorize the country as dependent on either trade flow or capital flow. Trade flow means how much income a country earns through trade and Capital flow means how much investment a country attracts from abroad. Some countries are sensitive to trade flows, while others are far more dependent on capital flows. Countries whose currency strength depends on their trade flows include: \* Canada \* Australia \* New Zealand \* Japan \* Germany. These countries achieve a huge part of their growth through the export of various commodities. In the case of Canada oil is the primary (main) source of revenue. For Australia, industrial and precious metals dominate trade and in New Zealand, agricultural goods are a crucial source of income. Trade flows are also important for other export-dependent countries such as Japan and Germany.

For countries like US and UK capital flows are of greater importance because of large liquid investment market. In these countries financial services are principal. In fact in the US, financial services represented 40% of the total profits of the S&P 500. The United States also serves as a perfect example of why it is crucial to understand which flows affect which country in order to effectively analyze the direction of currencies. On the surface, the US currency with its record multi-billion dollar trade deficit and near \$1 trillion current account deficit should depreciate significantly. As the chart below illustrates, the US has been able to attract more than enough surplus capital from the rest of the world to offset the negative effects of its massive trade deficits. For the time being,

trade-flow deficits do not matter to the dollar. However, it should the US become unable to attract enough capital flow to offset its deficits.

## **Uridashi Bond Prediction Returns 40 Pips**

New Zealand has one of the highest interest rates January 2007 it was 7.25% in the developed world and because of that fact it is a major destination for capital flow. On January 22, 2007, there was talk of Uridashi bonds being issued to the benefit of the NZD. Uridashi bonds are issued when companies want to denominate their debt in a higher yielding currency and then offer it to Japanese investors. For these popular because the yield offered is far higher than the yield that Japanese investors can earn at home, which is less than 1%. We anticipated that the week's Uridashi issuances would inspire capital flow into New Zealand as investors purchased the bonds in New Zealand dollars.

Once we made this prediction, we had to decide which New Zealand currency pair we would trade to best take advantage of the movement of the New Zealand dollar. We considered both the NZD/USD pair and the NZD/JPY. We decided to go long the New Zealand dollar against the US dollar instead of against the Japanese yen. The risk/reward ratio to go long NZD/JPY versus NZD/USD was not as attractive. Our stop in the NZD/USD was more conservative than the risk we would have assumed in NZD/JPY. Therefore, we went long NZD/USD and banked 40 points over the next 24 hours. New Zealand dollar vs. United States dollar, January 22, 2007. We traded the New Zealand dollar / United States dollar on January 22. The trade returned 40 points in 24 hours. New Zealand dollar vs. Japanese yen, January 22, 2007. The New Zealand Dollar / Japanese yen trade would have been a higher risk than the above-chart NZD/USD trade.

## **FACTOR 5: Mergers and Acquisitions**

Merger and acquisition activity is the least important factor in determining the long-term direction of currencies. It can be the most powerful force in staging near-term currency moves. When a company from one economic region wants to make a transnational transaction and buy a corporation from another country the merger and

acquisition activity occurs. For example for a European company wants to buy a Canadian asset for \$20 billion and it would have to go into the currency market and acquire the currency to affect this transaction. In general, these deals are not price sensitive but it is time sensitive because the acquirer may have a date by which the transaction is to be completed. Because of this underlying dynamic merger and acquisition flow can exercise a very strong temporary force on FX trading which sometimes skewing the natural course of currency flow for days or weeks. If you keep side by side of international merger and acquisitions you may be able to predict short-term fluctuations in FX. For example, in late 2006, Canadian economic data showed a great deal of weakness. Yet large demand for Canadian corporate assets from the Asia, Middle East, and Europe overrode the financial reports and kept the USD/CAD at all-time lows.

## **USD/CAD trades inversely**

In November of 2006, we made a healthy profit by predicting a backward acquisition effect: After a surprising government announcement, money that had been used to purchase equities in Canada, reversed flow and headed out of the country.

## **Canada Loses Investors, Inspires Big Forex Gains**

Merger and acquisition activity can be a powerful but sometimes silent driver of demand in the currency market. When a country's capital assets such as equities suddenly find help from the rest of the world and they indirectly affect pricing in the foreign exchange market as dealmakers first have to buy the country's currency before they can buy the stock. In the fall of 2006, Stephen Harper's newly elected conservative government made a shocking announcement that the very popular Canadian income trusts which enjoyed certain tax advantages would be taxed just like other Canadian securities. The Harper government exacerbated the situation by not grandfathering any of the long-term investors who already held positions in income trusts. We thought the impact of this news would be highly negative to the Canadian dollar as foreign capital would speedily flow out of the country. Despite lackluster US economic news at the time, we thought a USD/CAD trade

would be profitable because news that affects immediate investment flows typically overwhelms any day to day economic data. Therefore, on November 1, 2006 we went long USD/CAD at 1.1290 and were able to bank 45 points in just a few hours.

## **ANALYSIS**

From the personal interview I would come across that these five factors are very important in the moving of forex market. I had taken interview of Mr. Darshan Soni from the Darshan Forex. They informed me about the forex market and also give some guidance of that how to move the forex market and also they told that speculation affects more in the forex market. Currency speculation is measured a highly suspect activity in many countries. While investment in traditional financial instruments like bonds or stocks often is considered to contribute positively to economic growth by providing capital but currency speculation does not according to this view. It is simply gambling that often interferes with economic policy.

## **CASE STUDY**

### **CASE STUDY 1**

Hedging interest rate risk

#### **Scenario**

A major aircraft manufacturer has decided to replace his mainframe computer. The cost after trade in is \$ 10 million, payable on delivery.

#### **Delivery**

Mid December, 2006.

## **Funding**

A projected cash flow short fall will create a \$ 10 million borrowing requirement.

## **Borrowing Rate**

LIBOR + 50 Basis points

## **Outlook**

The treasurer is worried that the central bank's future policy directions will lead to an increase in short term rates.

## **Market Conditions**

Current LIBOR - 8.38 %

## **Euro-Dollar Options On Futures :**

December 91.25 (implied rate of 8.75%) Put, Premium of .25 December 91.00 (implied rate of 9.00%) Put, Premium of .15

## **Strategy**

The treasurer buys the December Put Option with a strike price of 91.25 (implied rate of 8.75%), which allows the manufacturer to enter into a Euro - Dollar futures contract for a premium price of .25. the notional principal, that is the size of the contract is \$ 1 million, so ten contracts are taken to cover the full short-term borrowing cost. The put will make money only if the underlying future falls below the strike price less the price paid for the option. Remember, the Euro-Dollar future is quoted as an index on a base of 100, a lower price means a higher rate of

interest

## **Results**

In Mid-December, depending upon how the LIBOR rate has changed, the treasurer will use or not use the put option on the future which was purchased. If the cost of short-term borrowing has remained the same or declined, the put option will expire worthless. The money expended upon the premium, of 0.25 % per \$ 1 million contract, will have been lost. If, however, interest rates were to rise, the put option contract on the Euro-Dollar future will be exercised. If, for example, Euro - Dollar Rates rise to 10.76% (89.10 on the index) which would have given the treasurer a borrowing cost of 11.26% (LIBOR + 50 bases points), the Put would be utilised, exercising the right to sell the option on the future at the strike price of 91.25, for an intrinsic value of 2.1 (Or 2% in interest terms). The gain in value on the Put options contract compensates for the increased cost of borrowing on the LIBOR Rate. The risk of funding the new mainframe computer has been managed.

## **CASE STUDY 2**

### **Hedging foreign exchange rate risk**

#### **Scenario**

An American manufacturer of clothing imports fabric from the United Kingdom. In 6 months time, in anticipation of the 2005-06 winter season, he will need to purchase 1 million Pounds Sterling, in order to pay for the desired imports, in order for his finished goods to be competitive and ensure adequate margins, the exchange rate must not fluctuate significantly. A weakening of the US dollar by more than 5% may create problems in terms of price competitiveness and profit margins.

## **Delivery**

In Mid June, 2005, the manufacturer is scheduled to receive and pay for the imports.

## **Funding**

The manufacturer has no funding exposure as the imports will be paid from working capital.

## **Exchange Rate**

The present rate is STG/ USD = 1.60, which is satisfactory with respect to commercial objectives, but a weakening of more than 5% will result in diminished margins or a non competitive position.

## **Outlook**

The manufacturer is worried that because of declining rates of interests and the current account deficits, the US dollar may waken against the Pound Sterling, from its current rate of 1.50.

## **Market Conditions**

Current spot rate - STG/USD = 1.60 June calls @ strike price of STG/USD = \$1.61, premium of 2.50% per contract, that is 4 US cents. June calls @ Strike price of STG/USD = \$1.62, premium of 2.00% per contract, that is 3 US cents.

## **Strategy**

The manufacturer buys one call option contract with a Strike or Exercise price of 1.61. If the US dollar weakens the call contract will be used to buy the Pounds - Sterling at the set price. If, the US dollar stays the same or strengthens, the contract will expire worthless and the premium paid for the option will have been lost.



## Results

In June 2005, the US dollar does weaken and the new spot exchange rate is STG/USD = 1.70. Hence, the call option at 1.61 has intrinsic value of 9 US cents. Instead of the 1 million Pound Sterling required by the manufacturer costing 1.6 million US dollars, the exercise of the call contract will net \$ 90000 US ( \$ 1.6 million - \$ 1.61 million). After subtracting the price of the premium of 2.5%, the net gain will be \$ 50000 US ( \$ 1.6 million - \$ 1.65 million), which partially off-sets the depreciation in the US Dollar exchange Rate, and is within the manufacturer's target range of 5% to remain competitive on pricing. Through this hedging technique the underlying commercial objective will be ensured. If the US Dollar exchange rate had not weakened, the expenditure on the premium would still have kept his net cost of the imports within the self imposed 5% competitive range.

## RECOMMENDATIONS

1. RBI should play a greater role in supporting Forex derivatives.
2. Derivatives market should be developed in order to keep it at par with other derivative markets in the world.
3. Speculation should be discouraged.
4. There must be more derivative instruments aimed at individual inves

tors.

5. SEBI should conduct seminars regarding the use of Forex derivatives to educate individual investors

## CONCLUSION

The Forex analysis is relatively simple to understand. Interest rates, economic growth, politics, trade and capital flows, and merger and acquisition activity are the five primary forces that move prices in the currency market. However, while the factors that drive trade are clear-cut and actual currency trading can be very tricky. To

forecast the Forex market you must be able to predict the endless interplay of each of the five forces affecting a currency pair. A currency pair typically driven by economic growth may suddenly be overtaken by influences in trade flows or short-term acquisitions. A pair that seems sure to fluctuate with interest rates may unexpectedly be held back by investors' response to political unrest. In a universe with a single currency, there would be no foreign exchange market, no foreign exchange rates, and no foreign exchange.

But in our world of mainly national currencies, the foreign exchange market plays the crucial role of providing the essential machinery for making payments across borders, transferring funds and purchasing power from one currency to another and determining that singularly important price, the exchange rate. Over the past twenty-five years the way the market has performed those tasks has changed extremely. Foreign exchange market plays a vital role in integrating the global economy. It is a 24-hour in over the counter market and made up of many different types of players each with its set of rules, practice & disciplines. On the other hand the market operates on professional bases & this professionalism is held together by the integrity of the players. The Indian foreign exchange market is no exception to this international market requirement. With the liberalization, privatization & globalization initiative in India the Indian foreign exchange markets have been reasonably liberated to play there efficiently.

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## QUESTIONNAIRE

1. NAME:

2. SEX: AGE:

3. OCCUPATION:

4. MONTHLY INCOME: Less than 100000 More than 100000

5. Do you have any interest in Forex market? o Yes o No

6. Do you trade in the forex market? o Yes o No

7. Is different rates are affecting forex market? o Yes o No

8. Which interest rate affect badly to forex market? o CRR o SLR o Repo rate o Reverse Repo rate

9. Whether news on Interest rates will affect positively or negatively on forex market? o Positively o Negatively o Depends on news o Depends on rates

10. If the Capital account increases then will it affect forex market positively or negatively? o Positively o Negatively o Depends on country

11. Will current account news affect on the forex market? o Yes o No

12. Will stable government affect positively on forex market? o Yes o No o Depends
13. If in the election if government comes on alliance bases then how it will affect forex market? o Positively o Negatively o Depends on government
14. Will government of the country affect the forex market? o Yes o No o Depends on forex market
15. If forex market is growing and booming will it be help full for government? o Yes o No o Depend on Investors o Depends on government how they take advantage
16. Will booming forex market help government to run country? o Yes o No o May be o Depends
17. Is merger and acquisition of the company help to rise in the price of shares of that company? o Yes o No o Beneficial for both the company o Beneficial for company as well as inventors'
18. Do these economic indicators like GDP, Inflation, PCI etc. affect forex market? o Yes affect a lot o Yes o No o Never
19. Which of the following factor AFFECT the most to the forex master? Give parameter between 1 to 5 1= Highest 5= Lowest Factors Parameters between 1 to 5 Comment (Why) INTEREST RATE TRADE AND CAPITAL FLOWS GEO-POLITICAL MERGERS AND ACQUISITIONS ECONOMIC GROWTH Speculation How Speculation affect forex. Is Speculation is most important factor that drives forex market apart from all other factors which are mention in above table?

## Response sheet

### RESPONSE SHEET - 1

Name: MAUNESH SHAH Id no: SS/08-10/AHD/MKTG/17 Topic: "FIVE KEY FACTOR THAT MOVES THE FOREX MARKET" Date of Meeting: 05/11/2009 Details of meeting: · Discussion on topic · Research to be used Outcome: · Basic clarity on topic · Insightful thought provoked, Progress: · Huge clarity · Need review the literature

## Response sheet-2

Name: MAUNESH SHAH Id no: SS/08-10/AHD/MKTG/17 Topic: "FIVE KEY FACTOR THAT MOVES THE FOREX MARKET" Date of Meeting: 25/11/2009 Details of meeting: · Discussion on topic · Research to be used Outcome: · more clarity on topic · Data collected Progress: · work On the proper path · Need review the literature and some own thought

## Response sheet-3

Name: MAUNESH SHAH Id no: SS/08-10/AHD/MKTG/17 Topic: "FIVE KEY FACTOR THAT MOVES THE FOREX MARKET" Date of Meeting: 10/12/2009 Details of meeting: · Discussion on topic · Research to be used/ primary research Outcome: · Clear direction on how to proceed · Resubmission of chapters with graphs and better representation Progress: · Research methodology needs to be revamped and submitted, · Data collection to be done

## Response sheet-4

Name: MAUNESH SHAH Id no: SS/08-10/AHD/MKTG/17 Topic: "FIVE KEY FACTOR THAT MOVES THE FOREX MARKET" Date of Meeting: 10/01/2010 · Data collection has shown · Analysis of the same data checked and validated with result Outcome: · Discussion on topic Verified by Visa and Payment Gateway Mechanism. Progress: · Progress is very good and detailed understanding of thesis has been made. · Creativity increased on how to make data in forms of table and pictures

## Response sheet-5

Name: MAUNESH SHAH Id no: SS/08-10/AHD/MKTG/17 Topic: "FIVE KEY FACTOR THAT MOVES THE FOREX MARKET" Date of Meeting: 20/01/2010 Details of meeting: · Previous submission of chapters and understanding the same · Discussion further chapter Outcome: · Understanding with more details and work on new

methodology for research · Precise study of samples to be used in data collection along with methodology,  
Progress: · Primary survey to be undertaken a part of thesis

## **Response sheet-6**

Name: MAUNESH SHAH Id no: SS/08-10/AHD/MKTG/17 Topic: "FIVE KEY FACTOR THAT MOVES THE FOREX MARKET" Date of Meeting: 25/01/2010 Details of meeting: · Study of thesis and the concepts for viva · Lasted whole day Outcome: · Clarity on formation of chapters and indexing · perspicacious concept clarity · thesis is completed with excellent understanding and strategy formulation Progress: · Thesis is completed in as very good manner and in proper timings · Meeting if any discussion in future required would be undertaken using present analysis.