1 Introduction

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1.1 THE FOREIGN EXCHANGE MARKET

The foreign exchange market is by far the largest financial market in the world and thrives on its enormous ocean of money. It trades across the world with an estimated $ 3.2 trillion* global average daily volume, which solidifies foreign exchange as an asset class. It is distinguished from other markets, for example the commodity or equity markets, by having no fixed base – no centralized marketplace. In other words, the foreign exchange market exists at the end of a telephone, the Internet or other means of instant communication; it is not located in a building, nor is it limited by fixed trading hours. Hence, unlike equities, foreign exchange has not traditionally traded in one single location, such as on a regulated exchange, but it has always been a disjointed market where trading primarily takes place in an over-the-counter market where buyers and sellers conduct business. The foreign exchange market is truly a 24-hour global trading system where traders of all types and sizes can participate. It knows no barriers and trading activity in general moves with the sun from one major financial centre to the next, starting with Wellington and Sydney and moving through the time zones and trading centres of Tokyo, Hong Kong, Singapore, London and New York to the West Coast of America. Anything that happens anywhere in the world, no matter at what time of the day or night, like terrorist attacks, US sub-prime market woes, geopolitical tensions over nuclear power, oil supply problems and pricing, and many other issues which can threaten to disrupt trade and economic relationships, will affect the foreign exchange market instantly. Reports and events reported in Japan will have an effect on happenings in all foreign exchange trading centres across the globe, thus making foreign exchange a truly global trading asset.

* *BIS Triennial Central Bank Survey of FX and Derivatives Market Activity in April 2007, published September and December 2007*

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The foreign exchange market is a global network of buyers and sellers of currencies.

Foreign exchange or FX or Forex comprises all claims to foreign currency payable abroad, whether consisting of funds held in foreign currency with banks abroad, or bills or cheques payable abroad; i.e. it is the exchange of one currency for another.

A foreign exchange transaction is a contract to exchange one currency for another currency at an agreed rate on an agreed date.

1.2 VALUE TERMS

Throughout history, one person has traded with another, sometimes to obtain desired raw materials by barter, sometimes to sell finished products for money, and sometimes to buy and sell commodities or goods for no other reason than to make a profit from the transactions involved. The pre-historic ‘bartering’ of goods and the use of cowrie shells or similar objects of value as payment eventually gave way, approximately 4000 years ago, to the use of coins struck in precious metals. Even in those far-off days, there was international trade and payments were settled in any coinage that was acceptable to both parties. Early Greek coins, which were almost universally accepted in the then known world, were soon given values in terms of their models, and a price for any raw material or finished goods could be quoted in value terms of either Greek originals or other nations’ copies.

The first forward foreign exchange transactions can be traced back to the money-changers in Lombardy in the 1500s. Foreign exchange, as we know it today, has its roots in the Gold Standard, which was introduced in 1880. It was a system of fixed exchange rates in relation to gold and the absence of any exchange controls.

1.3 COFFEE HOUSES

Banking and financial markets closer to those of today were started in the coffee houses of European financial centres, such as the City of London. In the seventeenth century these coffee houses became the meeting places not only of merchants seeking to trade their finished goods, but also of those who bought and sold solely for profit. It is the City of London’s domination of these early markets that saw it maturing through the powerful late Victorian era, and it was strong enough to survive two world wars and the depression of the 1930s.

1.4 SPOT AND FORWARD MARKET

Today, foreign exchange is an integral part of our daily lives. Without foreign exchange, international trade would not be possible. For example, a Swiss watchmaker

will incur expenses in Swiss francs. When the company wants to sell the watches, they want to receive Swiss francs to meet those expenses. However, if they sell to an English merchant, the English company will want to pay in sterling, the home currency. In between, a transaction has to occur that converts one currency into the other. That transaction is undertaken in the foreign exchange market. However, foreign exchange does not only involve trade. Trade, today, is only a small part of the foreign exchange market; movements of international capital seeking the most profitable home for the shortest term dominates.

The main participants in the foreign exchange market are:

- Commercial banks – participate in the markets from the point of view of managing their own foreign exchange risks and that of their clients, and should they have a particularly strong view will also speculate on currency movements.
- Commercial organisations – by the nature of their business, companies could engage in commercial or capital transactions that require them to enter the currency markets to either buy or sell foreign currencies.
- Brokers – acts as a middleman in the same way as a stockbroker in the equities market, but brokers confine their activities to acting between banks and do not accept orders from corporate or retail clients.
- Central banks – their role tends to be diverse and can differ from country to country, however most are charged with the responsibility of maintaining an orderly market for the national currency.
- Fund managers – tend to invest across a range of countries and investment asset classes on behalf of their clients, for instance pension funds and individual investors.
- Hedge funds – have a tendency to be very aggressive in their investment approach and are generally concerned with managing the total risk of a pooled investment.
- Speculators – in the narrow sense of the financial markets, buy, hold and sell (and vice versa) to profit from fluctuations in foreign exchange prices.
- Retail traders and investors – a new breed of participant into the foreign exchange market and have the same goals as everyone else – to make money.

Most participants transact in foreign currency, not only for immediate delivery but also for settlement at specific times in the future. By using the forward markets, the participant can

A spot transaction is where delivery of the currencies is two business days from the trade date (except the Canadian dollar, which is one day).

A forward transaction is any transaction that settles on a date beyond spot.

determine today the currency equivalent of future foreign currency flows by transferring the risk of currency fluctuations (hedging or covering foreign currency exposure). The market participants on the other side of any trade must either have exactly opposite hedging needs or be willing to take a speculative position. The most common method used by participants when transacting in either spot or forward foreign currency is to deal directly with a bank, although Internet trading is currently making impressive inroads.

These banks usually have large foreign exchange sales and trading departments that not only handle the requests from their clients but also take positions to make trading profits and balance foreign currency positions arising from other bank business. Typical transactions in the bank market range from $ 1 million to $ 500 million, although banks will handle smaller amounts as requested by their clients at slightly less favourable terms.

1.5 ALTERNATIVE MARKETS

In addition to the spot and forward markets, other markets have been developed that are gaining acceptance. Foreign currency future contracts provide an alternative to the forward market and have been designed for dealing with major currencies. These contracts have the advantages of

A currency future obligates its owner to purchase a specified asset at a specified exercise price on the contract maturity date.

smaller contract sizes and a high degree of liquidity for small transactions. The disadvantages include the inflexibility of standardized contract sizes, maturities, and higher costs on large transactions. Options on both currency futures and on spot currency are also available. Another

An option gives the owner the right but not the obligation to buy or sell a specified quantity of a currency at a specified rate on or before a specified date.

technique that is used to provide long-dated forward cover of foreign currency exposure, especially against the currency flow of foreign currency debt, is a foreign currency swap.

A foreign currency swap is where two currencies are exchanged for an agreed period of time and re-exchanged at maturity at the same exchange rate.

CONCLUDING REMARKS

In summary, the foreign exchange market is open for business 24-hours a day (almost seven days a week but not quite) with liquidity not being a major problem in most locations. In addition, with the advances in technology, trading over electronic platforms is becoming the norm, where foreign exchange trades are executed instantaneously. Plus, the foreign exchange market provides some of the highest leverage of any investment instrument, where it is possible to trade a sizeable position with limited funds via margin trading. It is a market which will take into account gut feelings, fundamental, economic and technical factors with enough volatility to satisfy the majority. Simply put, foreign exchange is an efficient market whereby the rates quoted by any market participant reflects all news, supply and demand issues, which way the market is weighted and potentially resting orders.

Perhaps most importantly, the foreign exchange market has depth and breadth superior to any capital markets instrument. For instance, equities, whether cash or derivatives, are all subject to what is available in an ‘order book’ and orders of any size may have to be worked before being filled. On the other hand, a foreign exchange order could be filled at one rate in a reasonable size instantaneously.

Although activity in the foreign exchange market remains predominately the domain of the large professional players – for example, major international banks, such as Citigroup, JPMorgan, HSBC and Deutsche Bank, it does not mean that the market is totally dominated by or controlled by such institutions. Other players also live in this market and include amongst others corporations, fund managers, brokers, speculators and retail investors. Though a bank’s scale of trading is vast compared to the average retail trader, they are all concerned by and affected by the same issues and happenings of the day. When all said and done, all participants, whether large or small, seek to make a profit out of their activities in the foreign exchange market. However, with liquidity and the advent of Internet trading, plus the availability of margin trading, this 24-hour market requires a much disciplined approach to trading, as profit opportunities and potential loss are equal and opposite.