Mohamed Khaider University, Biskra

Faculty of Economics, Commerce and Management Sciences

Commerce Department

Module: International Finance

Branch: International Trade
Level: Third year Bachelor

Lecture 05: The Market for Foreign Exchange

Learning Outcomes

When you have completed your Study of this unit and its readings, you will be able to:

- Identify the meaning of foreign exchange market

- Introduce the institutional structure of foreign exchange market

- Elaborate on the important market participants

1- Definition of foreign exchange market

The market for foreign exchange is the largest financial market in the world by virtually any standard. Broadly defined, the foreign exchange (FX or Forex) market encompasses the conversion of purchasing power from one currency into another, bank deposits of foreign currency, the extension of credit denominated in a foreign currency, foreign trade financing, trading in foreign currency options and futures contracts, and currency swaps. Obviously, one chapter cannot adequately cover all these topics.

2- Organization of foreign exchange market

a- Institutional Structure

The structure of the foreign exchange market is an outgrowth of one of the primary functions of a commercial banker: to assist clients in the conduct of international commerce -Foreign exchange risks. For example, a corporate client desiring to import merchandise from abroad would need a source of foreign exchange if the import was invoiced in the exporter's home currency. Alternatively, the exporter might need a way to dispose of foreign exchange if payment for the export was invoiced and received in the importer's home currency.

The foreign exchange market should not be thought of as a specific building or location where traders exchange currencies. Companies normally exchange one currency for another through a commercial bank over a telecommunications network; this is an *over-the-counter (OTC)* market through which many transactions occur. *Over-the-counter (OTC)* market is not a physical trading place - trading does not take place in a central marketplace- where buyers and sellers gather to agree on a price to exchange currencies. Traders, who are employees of financial institutions in the major financial cities around the world, deal with each other via computer or over the phone, with back office confirmations of transactions occurring only later.

b-Forex market participants

The foreign exchange market operates 24 hours per day because the major financial centers where currencies are traded are geographically spread out. When it is midnight in London, England, it is morning in the Pacific and Asian markets.

The market for foreign exchange can be viewed as a two-tier market. One tier is the wholesale or interbank market and the other tier is the retail or client market. FX market participants can be categorized into five groups: international banks, bank customers, nonbank dealers, FX brokers, and central banks.

International banks : provide the core of the FX market. They actively “make a market” in foreign exchange, that is, they stand willing to buy or sell foreign currency for their own account. These international banks serve their retail clients, the bank customers, in conducting foreign commerce or making international investment in financial assets that require foreign exchange.

Bank customers: broadly include MNCs, money managers, and private speculators. According to 2010 BIS statistics, retail or bank client transactions account for approximately 14 percent of FX trading volume

Nonbank dealers: are large nonbank financial institutions such as investment banks, mutual funds, pension funds, and hedge funds, whose size and frequency of trades make it cost-effective to establish their own dealing rooms to trade directly in the interbank market for their foreign exchange needs.

Forex Brokers : They do not attempt to buy low and sell high. Instead, brokers fulfill the role of a financial intermediary. They match buyers and sellers but do not put their own money at risk. They then receive a brokerage fee on their transactions. Brokers have knowledge of the quotes offered by many dealers in the market.

The central bank: It attempts to influence the price of its currency against that of a major trading partner, or a country that it “fixes” or “pegs” its currency against. Intervention is the process of using foreign currency reserves to buy one’s own currency in order to decrease its supply and thus increase its value in the foreign exchange market, or alternatively, selling one’s own currency for foreign currency in order to increase its supply and lower its price. For example, intervention that successfully increases the value of one’s currency against a trading partner may reduce exports and increase imports, thus alleviating persistent trade deficits of the trading partner. Central bank traders intervening in the currency market often lose bank reserves in attempting to accomplish their goal.

c-The efficient functioning of the foreign exchange market

The interbank market is a network of correspondent banking relationships, with large commercial banks maintaining demand deposit accounts with one another, called correspondent banking accounts. The Society for Worldwide Interbank Financial Telecommunication (SWIFT) allows international commercial banks to communicate instructions of the type in this example to one another. SWIFT is a private nonprofit message transfer system with headquarters in Brussels, with intercontinental switching centers in the Netherlands and Virginia. The Clearing House (CHIPS), formerly known as the Clearing House Interbank Payments System, in cooperation with the U.S. Federal Reserve Bank System, called Fed-wire, provides a clearinghouse for the interbank settlement for over 95 percent of U.S. dollar payments between international banks

d- Types of Contracts Traded: Many different types of trades can be conducted in the foreign exchange market. the spot market, where “spot” implies the market for immediate exchanges of monies. Another part of the interbank foreign exchange market involves trade in swaps and forward contracts, transactions that involve exchanges of currencies in the future.

4-Glossary:

Basket of currencies A composite currency composed of various amounts of other currencies

Correspondent bank A bank that performs services as a proxy for financial institutions that lack an on-site presence in a particular country.

Foreign exchange brokers Financial intermediaries in the foreign exchange market who do not put their own money at risk but who receive a brokerage fee for matching buyers and sellers of currencies.

Foreign exchange dealers Traders of currencies at commercial banks, investment banks, and brokerage firms in the major financial cities around the world

Forward market return The return on a forward market investment that represents the difference between the future spot rate and the forward rate for a long contract or the negative of that for a short contract

Interbank market The wholesale part of the foreign exchange and external currency markets where major banks trade.

5-Suggested Readings:

.Cheol S. Eun and Bruce G. Resnick. International Financial Management. Sixth edition. Published by McGraw-Hill/Irwin companies. New York. 2012

.Federal Reserve Bank of New York. The Foreign Exchange and Interest Rate Derivatives Markets: Turnover in the United States. New York: Federal Reserve Bank of New York, April 2007