CHAPTER 5

The Foreign Exchange Market

The Currency Market:
- Where one trades one nation’s currency for another's.
- Location: no specific central trading floor (except for currency futures and options).
- One trades with a Dealer: a middleman that holds an inventory in different currencies. Similar to the NASDAQ-OTC stock market.

Introduction
- The world’s currency markets are larger than any other financial market.
- In 1995: $1.2 trillion daily volume.
- Compared with stock markets: $7 billion daily on the NYSE.

Organization of the Foreign Exchange Market
- Participants at 2 Levels
  - Wholesale Level (95%) - major banks
  - Retail Level - small business customers.
- Two Types of Currency Markets: Spot and Forward.
- Spot Market: so-called “immediate” transaction is cleared by the 2nd business day (the “value date”).

Exchange rates quotations
- In the Wall Street Journal, major currencies have four different quotes:
  - a. spot price
  - b. 30-day
  - c. 90-day
  - d. 180-day
  - the last three being forward rates.

Introduction
- SIZE: Which market Centers Dominate?
  - London = $464 billion then...
  - New York = $244 billion
  - Tokyo = $161 billion
  - Singapore = $108 billion
  - followed by Hong Kong, Zurich, Frankfurt, and Paris.
Recall the methods of quotation
American terms are direct quotes in the U.S.,
indirect quotes elsewhere.
Example: $.5838/DM
European terms are indirect quotes in the U.S.,
direct quotes elsewhere.
Example: DM1.713/$

Transactions Costs
The Bid-Ask Spread: used to calculate the fee
charged by the bank
Bid = the price at which the dealer is willing
to buy the currency.
Ask = the price the dealer will sell the
currency.
Example for the GBP $1.6401-30 means the
dealer will buy pounds at $1.6401 and sell
them at $1.6430. The spread is 0.0029.

Percent Spread Formula (PS): the most relevant
measure of transactions costs.
Percent Spread = \( \frac{\text{Ask} - \text{Bid}}{\text{Ask}} \times 100\% \)
The PS (cost) varies directly with the currencies’
volatility and indirectly with the amount of
trading volume.

Exchange Risk for Currency dealers: As
middlemen, dealers keep an inventory in various
currencies.
Thus dealers incur the risk of adverse exchange
rate moves. Typically, if forex volatility rises,
the dealers require wider bid-ask spreads.
Trading volume: If inventory turns over slowly,
the dealers require a greater markup. Trades
with high volume (pound to dollar) would have
smaller spreads than dollar/zloty.

Cross Rates (from an American perspective):
the exchange rate between 2 non- US$ currencies.
Tables that include the U.S. dollar are available
in the WSJ, Bloomberg, and Yahoo financial.
Calculating Cross Rates
When you want to know what the DM/£ cross
rate is, and you know DM2/US$ and £.55/US$
then DM/£ = DM2/US$ ÷ £.55/US$
= DM3.636/£

Review of direct quote, using cross rates: the
home currency price of one unit of foreign
currency.
Example: DM0.25/FF
This is a direct quote in Germany.
And an indirect quote in France.