FINS1612 FINALS NOTES

WEEK 8, CH15: FOREIGN EXCHANGE MARKETS

- Exchange rate is the value of one currency relative to that of another currency

15.1 EXCHANGE RATE REGIMES

1. Floating exchange rate
    - Exchange rate is allowed to move as supply and demand dictate
    - The central bank will only intervene if there is significant and rapid appreciation or depreciation
2. Managed float
    - Allows the currency to move within a defined range, relative to another major currency
    - Can be used to maintain competitive trade equilibrium
    - Countries that use this regime include China, Singapore, Malaysia and Indonesia
3. Crawling peg
    - Allows currency to appreciate gradually over time, but within a limited range established by the government
4. Linked exchange rate
    - A currency is directly linked to another currency
    - The exchange rate is locked into a ratio with a nominated currency
    - Honk Kong uses this regime

15.2 FOREIGN EXCHANGE MARKET PARTICIPANTS

FOREIGN EXCHANGE DEALERS AND BROKERS

- The main FX dealers are the commercial banks, investment banks and merchant banks
- FX dealers quote two-way prices in the market – what they buy and sell
- FX brokers almost exclusively deal with FX dealers
    - They obtain the best prices in the global FX market and match FX dealers' buy and sell orders for a fee
- For example, a firm will go to a dealer for a quote and the dealer will meet demand from its own inventory or by acquiring currency through a broker

CENTRAL BANKS

- Central banks can change the composition of their foreign currency reserves
- They make international transactions and pay interest on overseas borrowings
- Can influence the exchange rate with a dirty float by intervening in the FX market

FIRMS CONDUCTING INTERNATIONAL TRADE TRANSACTIONS

- When exporters receive foreign currency for the sale of their goods and services they will sell the foreign currency and buy AUD
- Importers buy foreign currency and sell AUD

INVESTORS AND BORROWERS IN MONEY AND CAPITAL MARKETS

- Commercial banks borrow significant sums in the international capital markets as part of their active liability management strategies
    - A high proportion of these funds will be converted to the home currency
- Different groups also invest overseas where dividend or interest payments may be denominated in a foreign currency and need to be converted

SPECULATIVE TRANSACTIONS

- Motivated by the pursuit of profit
- At times, speculators are able to move the market price of a currency
- There is always an element of risk that your expectations won't be correct
- An example of an institutional speculator is hedge funds
- Example: if you expect AUD to depreciate against USD, you buy USD now and sell USD when AUD depreciates

ARBITRAGE TRANSACTIONS

- Possible when differences occur between buy and sell prices in markets
- Arbitrageur carries out simultaneous buy and sell transactions in two or more markets to achieve riskless profit
- Triangular arbitrage occurs when exchange rates between three or more currencies are out of perfect alignment

Triangular arbitrage

USD1 = AUD1.3525

USD1 = SGD1.3525

AUD1 = SGD 0.9870

Arbitrage strategy

Sell AUD1.3525 and receive USD1

Sell USD1 to receive SGD1.3525

Sell SGD1.3525 to receive AUD1.3703

15.4 SPOT AND FORWARD RATE TRANSACTIONS

- FX transactions are classified by the maturity date, otherwise referred to as the delivery date (or value date) of the relevant foreign currency
- Spot transactions have a maturity date of two business days after the spot contract is entered into
- Forward transactions set an exchange rate today for delivery and settlement in more than two days
    - The one-month forward rate will be the spot delivery date plus one month
- Short dated FX transactions may be tod (today delivery) or tom (delivery tomorrow)

15.5 SPOT MARKET QUOTATIONS

ASKING FOR A QUOTATION

- The first currency mentioned is the base currency or the unit of quotation – it is the price being sought
- The second currency in the FX quote is the terms currency and it is used to express the value of the base currency
- USD/EUR means the price of USD1 in terms of EUR