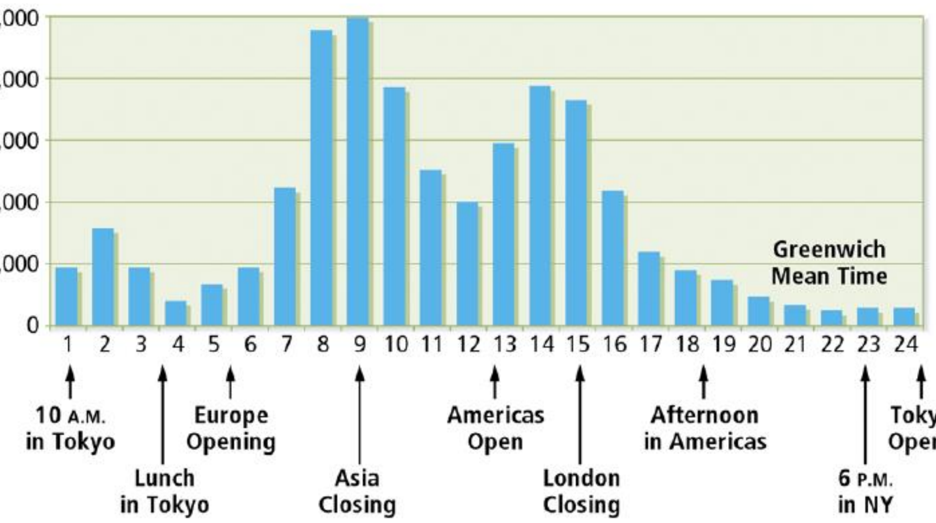
**FINC3011 International Financial Management**
**Topic 1: Foreign Exchange Markets and Exchange Rates I**

## The Organisation of the Foreign Exchange Market

The Foreign Exchange Market

- The foreign exchange (FX) market is the market in which national currencies are bought and sold, and exchange rates are determined.
- The FX market is the largest financial market in the world, measured by dollar volume of trade, and it has experienced tremendous growth in recent years.
    - The IBS estimated that: in 1973, daily trading volume was \$10-\$20b; in late 1980s, daily trading volume was \$500b; in 1993, daily trading volume was \$1t; in 2010, daily trading volume was \$3.9t.
    - This growth has been due to increased cross-border trades in goods, services and securities and an increase in speculative participation in the market by eg hedge funds.
- The FX market is an OTC market, such that there is no single physical location or organised exchange where traders congregate to exchange currencies. It is a complex international network of key participants, linked through telephone and electronic communication.
- The FX market operates 24hrs per day because the financial centres where currencies are traded are geographically spread out.
- The majority of trading takes place in key financial centres eg UK, US, Japan, Switzerland, and involves the exchange of the most popular currencies eg USD, Euro, Yen, British Pound, AUD, CAD, CHF.
- A FX transaction is an agreement between a buyer and seller to exchange a fixed amount of currency for another currency at a pre-specified rate.
- The functions of the FX market are as follows:
    - It facilitates the transfer of purchasing power between countries, which is necessary for international trade and capital transactions.
    - It allows parties to minimise, or hedge their exposure to exchange rate risk.
    - It facilitates the provision and acquisition of credit for international trade transactions.
- The FX market spans the globe, starting in Sydney and Tokyo and finishing on the west coast of the US daily. Trading volumes tend to move with the open and close of other key financial markets in the world. This is shown in the diagram below:




- The FX market consists of two tiers: the interbank or wholesale market (transactions amounts >\$1m) and the client or retail market.
- There are 5 main participants in the FX market:
    - Bank and non-bank FX dealers, who provide liquidity to the market by setting two-way quotes. Dealers profit from the bid-ask spread and may engage in arbitrage and speculation.
    - FX brokers, who facilitate trading between buyers and sellers without becoming principals in the transactions. Brokers profit by charging commission. Nowadays, a large part of the