FINS1612 Exam Notes

Understand the nature of global FX markets

- Floating exchange rate regime – the exchange rate for a country is allowed to move as factors of supply and demand
  - AUD, USD, GBP, JPY, EUR
- Not controlled by government or central bank (though it can influence the exchange rate when there is rapid appreciation or depreciation i.e. slow it down)
- Managed float regime – allows currency to move within a defined range relative to another currency
- Crawling peg regime – allows the currency to appreciate gradually over time but within a range established by the government
- Pegged rate – currency directly linked to another country

Discuss participants in the FX markets

- FX dealers and brokers
- Central banks – influence exchange rate, change composition of holdings of foreign currencies in managing official reserve assets, purchase foreign currency to pay government imports and interest on or redeem government debt
- Firms conducting international trade
  - Exporters – sell foreign currency and buy AUD
  - Importers – buy foreign currency and sell AUD
- Investors and borrowers in the international money markets and capital markets – investing overseas
- Foreign currency speculators – anticipate future rates to make a profit
- Arbitrageurs – no risk exposure;
  - Geographic – taking advantage of when two dealers in different locations quote different rates on same currency
  - Triangular – taking advantage of when 3 or more currencies are out of alignment

Describe the functions and operations of FX markets

- Operates 24 hrs a day
- Typically the same rates globally (no arbitrage profits available)
- Sophisticated global telecommunication systems utilised

Outline instruments traded in FX markets

- Spot transactions – set an exchange rate today for delivery and settlement in 2 business days
- Forward FX transactions – set an exchange rate today for delivery and settlement in more than two days (standards are in months)

Explain conventions for quotation and calculation of exchange rates and forward exchange rates, and complicating factors

- Convention of quotations: Base Currency/Terms Currency [bid]-[offer]
  - buy/sell is from dealer's point of view – dealer buys low sells high
  - e.g. USD/AUD0.95-0.96 means
    1 USD = 0.95(buy price] or 0.96[sell price]
  - Spread is calculated: (offer price – bid price)/bid price x 100