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 foreign exchange (FX or Forex) market is the largest financial market globally by almost any measure. It broadly includes the exchange of purchasing power between different currencies, foreign currency bank deposits, credit issuance in foreign denominations, financing for international trade, as well as trading in currency options, futures contracts, and swaps.

2- Organization of foreign exchange market

a- Institutional Structure

The foreign exchange market has evolved from one of the key roles of commercial banks: helping clients manage international trade and currency risk. For instance, an importing company may require foreign currency if the goods are invoiced in the exporter's currency, while an exporter may need to convert foreign currency into their local currency when paid in the importer's denomination.

Unlike a physical marketplace, the foreign exchange market does not exist in a single location where traders meet to exchange currencies. Instead, most currency transactions occur through commercial banks via telecommunications networks, forming an over-the-counter (OTC) market. In this decentralized system, financial institution traders in major global financial hubs conduct transactions electronically or by phone, with confirmations processed later by their back-office teams.

b- Participants in the Forex Market

The foreign exchange market operates around the clock due to the global distribution of major financial hubs. While it may be midnight in London, trading activity continues in the Pacific and Asian markets, ensuring continuous transactions.

The FX market consists of two main tiers: the wholesale (interbank) market and the retail (client) market. Participants in this market can be classified into five key groups: international banks, bank customers, nonbank dealers, FX brokers, and central banks.

- **International Banks:** These institutions form the backbone of the forex market by actively providing liquidity. They buy and sell currencies for their own accounts and facilitate transactions for retail clients involved in global trade or international investments requiring currency exchange.
- **Bank Customers:** This group includes multinational corporations (MNCs), investment managers, and private speculators. As of 2010 BIS statistics, transactions from bank clients accounted for about 14% of total forex trading volume.
- **Nonbank Dealers:** These are large financial entities such as investment banks, mutual funds, pension funds, and hedge funds. Due to the size and frequency of their transactions, they often maintain their own trading operations, allowing them to deal directly in the interbank market.
- **Forex Brokers:** Unlike dealers, forex brokers do not engage in speculative trading. Instead, they act as intermediaries, matching buyers and sellers without taking financial risks themselves. Their earnings come from brokerage fees, and they have extensive knowledge of price quotes offered by various dealers.
- **Central Banks:** These institutions intervene in the forex market to regulate the value of their national currency, especially in relation to key trading partners or currencies to which they peg their exchange rate. Intervention typically involves buying domestic currency using foreign reserves to reduce supply and increase value, or selling domestic currency to increase supply and lower its price. Such actions influence trade balances, as a stronger currency may reduce exports and boost imports. However, central banks often deplete their reserves when intervening in currency markets.

c- Efficient Operation of the Foreign Exchange Market

The interbank foreign exchange market operates through a network of correspondent banking relationships, where large commercial banks hold demand deposit accounts with each other, known as correspondent banking accounts. To facilitate communication and transaction processing, international banks use the Society for Worldwide Interbank Financial Telecommunication (SWIFT), a private, nonprofit messaging system headquartered in Brussels, with major switching centers in the Netherlands and Virginia. Additionally, the Clearing House Interbank Payments System (CHIPS), in collaboration with the U.S. Federal Reserve's Fedwire system, processes and settles over 95% of U.S. dollar transactions between global banks.

d- Types of Forex Market Contracts

Various types of transactions take place in the foreign exchange market. The spot market facilitates immediate currency exchanges, allowing transactions to be settled promptly. Additionally, the interbank forex market includes swaps and forward contracts, which involve agreements to exchange currencies at a future date, providing flexibility for managing currency risk.

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