Foreign Exchange Markets and Foreign Exchange Rates

A foreign exchange market is a market where a convertible currency is exchanged for another convertible currency or other convertible currencies. In the transaction or execution of conversion, one currency is considered domestic and the other is regarded as foreign, from a certain geographical or sovereign point of view, so is the term foreign exchange derived. Foreign exchange markets are not reserved for traders or finance professionals only but for almost everyone, from multinational corporations operating in several countries to tourists travelling across two currency zones. As long as national states or blocs of national states that adopt their own currencies exist, foreign exchange markets will persist to serve business, non-business, and sometimes, political needs of business firms, governments, individuals, and international organizations and institutions.

An exchange rate is the price of one currency in terms of another currency; it is the relative price of the two currencies. The initial and foremost roles of money are to function as a common measure of value and the media of exchange to facilitate the exchange of commodities of different attributes. When the values of commodities of different attributes are readily denominated by certain units of a currency or a kind of money circulated in a country or region, the relative price, or the ratio of values, of two commodities can be easily decided. The relative price of two commodities can be decided without the involvement of money, though less explicit. So, more important is the role of money as the media of exchange, for it is the bearer of commonly recognised value, exchangeable for many other commodities then or at a future time. Instead of barter trade where change of hands of two commodities is one transaction conducted at one place and at one time, people do not need to sell one commodity in exchange for another commodity or other commodities directly and immediately, but sell the commodity for certain units of a currency or a kind of money in which the value of the sold commodity is “stored” for future use.

In international trade, the situation is slightly different from that in domestic trade in that the value of one commodity is denominated in two or more currencies. In theory it is straightforward to derive the exchange rate between two currencies, which is simply the ratio of the units of one currency required to purchase, or obtained from selling, the commodity in one country or region to the units of the other currency required to purchase, or obtained from selling, the same com-

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commodity in the other country or region. Indeed, this is the idea of so called purchasing power parity, or PPP for abbreviation, an important theory and benchmark of studies in international finance. Unfortunately, this world is not a simple and care-free place. Different countries may not always produce identical products that possess the exactly same attributes, or some countries do not produce certain products at all, which leads to the needs of international trade on the one hand, and makes international comparison of commodities and consumptions difficult on the other hand. Then, transportation and physical movements of export goods incur additional costs, and governments of national states and trade blocs impose tariffs on imported goods that distort the total costs for the consumption of a wide range of commodities. Besides, national and regional borders prevent human beings, either as a factor of production or consumers, capital, technology, natural resources and other factors of production from moving freely between countries and regions, which further cause and enlarge differences in income, preference, culture, means of production and productivity, economic environments and development stages in different countries and regions. All of these influence exchange rates and are the determinants of exchange rates to varied extents. Theories incorporating one or more of these factors and determinants have been developed over the last few decades and will be gradually unfolded and examined in the later chapters of this book.

1.1 Foreign Exchange Rate Quotations and Arbitrage

Foreign exchange rates can be quoted as the number of units of the home or domestic currency per unit of the foreign currency, or as the number of the foreign currency units per domestic currency unit. Moreover, since more than one pairs of currencies are usually transacted on the foreign exchange market, the cross exchange rate or the cross rate arises. The cross rate refers to the exchange rate between two currencies, each of which has an exchange rate quote against a common currency. When there are discrepancies in different cross rate quotations arbitrage and arbitrage activities may take place.

1.1.1 Foreign Exchange Quotations

Foreign exchange rates can be quoted directly or indirectly. In a direct quotation, the exchange rate is expressed as the number of units of the home or domestic currency per unit of the foreign currency. An indirect quotation is one that the exchange rate is expressed as the number of the foreign currency units per domestic currency unit. For example, the exchange rate between the US dollar and the euro was quoted on September 19, 2003 in Frankfurt as €0.8788/$ and $1.1380/€. The former is a direct quotation and the latter is an indirect quotation, from the point of view of Germany or the euroland as the domestic country.