INVESTMENT BASICS

Currencies: Basics

The currency market is the largest and most liquid financial market in the world. Currencies like the U.S. dollar, the euro and the yen trade in the foreign exchange (FX) market 24 hours a day, fluctuating in value relative to each other almost constantly. However, the currency market is also one of the least understood, and this article aims to explain the basics of currencies, the FX markets and the role of currencies in investing.

Overview of the Global Currency Markets

Currency describes the money or official means of payment in a country or region. The best-known currencies include the U.S. dollar, euro, Japanese yen, British pound and Swiss franc. Currency symbols exist for most currencies, such as $, €, ¥ or £. The foreign exchange markets, however, use ISO (International Organization for Standardization) codes to identify currencies. Some of these ISO codes are included in the chart below:

Major Developed Currencies		Select Emerging Currencies	
ISO	Currency Name	ISO	Currency Name
USD	U.S. dollar	BRL	Brazilian real
JPY	Japanese yen	CNY	Chinese renminbi (yuan)
EUR	Euro	SGD	Singapore dollar
GBP	British pound	PHP	Philippine peso
CHF	Swiss franc	MXN	Mexican new peso
NOK	Norwegian krone	INR	Indian rupee
SEK	Swedish krona	IDR	Indonesian rupiah
AUD	Australian dollar	MYR	Malaysia ringgit
NZD	New Zealand dollar	PLN	Polish zloty
CAD	Canadian dollar	KRW	South Korean won

Every day, trillions of dollars in currencies change hands in a highly professional interbank market, in which electronic trading platforms link currency traders from banks across the world. FX markets are effectively open 24 hours a day thanks to global cooperation among currency traders. At the end of each business day in Asia, traders pass their open currency positions to their colleagues in Europe, who – at the end of their business day – pass their open positions to U.S. traders, who then pass positions back to Asia at the end of their business day. And the cycle begins anew. This makes FX truly global and very liquid.

What Determines Exchange Rates?

The exchange rate gives the relative value of one currency against another currency. An exchange rate GBP/USD of two, for example, indicates that one pound will buy two U.S. dollars. The U.S. dollar is the most commonly used reference currency, which means other currencies are usually quoted against the U.S. dollar.

What determines the exchange rate between currencies? The most common theory to explain the relationship between two currencies that can change in value is the purchasing power parity theory, which can be illustrated with the “Big Mac index” created by *The Economist* magazine. In a perfect world, a Big Mac should have the same value everywhere in the world, regardless of the local currency. In a simplified example, assuming the exchange rate between the British pound and the U.S. dollar is two and the price of a Big Mac is £2.50 in the U.K., a Big Mac should cost $5 in the U.S. If the

purchasing power of the British pound increases relative to that of the U.S. dollar, the exchange rate has to adjust so that the pound buys more dollars than previously. Otherwise, consumers will start to buy goods in the cheaper country.

A similar principle applies when looking at money itself and considering interest as the price for money. If the real return (adjusted for inflation) on a financial asset differs between two countries, investors will flock to the country with the higher returns. Interest rates have to change to stop this movement. The theory behind this relationship is called the interest rate parity theory. (When looking at interest rates, it is important to distinguish between real rates and nominal rates, with the difference reflecting the rate of inflation. The higher the expected inflation in a country, the more compensation investors will demand when investing in a particular currency.)

A Brief History of Modern Currency Systems

Trading in currencies has not always been as active as it is today, mainly because exchange rates were not flexible, or "free floating," as most major currencies are today. In the nineteenth century, governments began to back their currencies with gold reserves so the value of a currency was fixed at a certain amount of gold. This gold parity provided stability in the value of the currency and gave people confidence in the currency. The U.K. introduced this "gold standard" in 1821, and by the beginning of the twentieth century, most major players in world trade had followed.

Under the gold standard, a government or central bank had to maintain enough gold reserves to match money supply in that country and ensure full convertibility of the currency against gold at all times. In times of war or crisis, maintaining sufficient gold reserve levels was difficult. During World War I, many countries had to abandon the gold standard. In the late 1920s, the "gold exchange standard" was introduced which allowed the exchange of a local currency for gold or for other currencies that were still backed by gold, such as the British pound and the U.S. dollar. Thus, the first "reserve currencies" were born. However, the economic crisis that began in 1929 took its toll; in 1931, the U.K. suspended the gold standard and many other countries followed.

At the end of World War II, another system of fixed – but adjustable – exchange rates was developed with the Bretton Woods agreement among 40 countries, which tied their currencies to the U.S. dollar. In return, the U.S. agreed to maintain a gold standard. Bretton Woods was abandoned in the 1970s after the U.S. gave up the gold standard.

Fixed exchange rates still exist today. The Chinese yuan, which is pegged to the U.S. dollar, is one of the most prominent examples. But most major economies today have free-floating currencies, allowing exchange rates to adjust to economic and market developments. The emergence of floating currencies is often credited for improving financial stability worldwide. In many countries, an independent central bank, such as the U.S. Federal Reserve or the Bank of England, watches over the stability of the nation's currency.

Countries in what is now the European Monetary Union agreed over the course of several decades to create a common economic area with one common currency. In January 1999, exchange rates for the new currency, the euro, were fixed for 11 participating countries. The euro began its life as an accounting currency before euro coins and notes replaced national currencies, including the Deutsche mark and the French franc, in 2002. The European Central Bank (ECB) is responsible for monetary policy in the entire eurozone and still has to consider the varying degree of economic development in the eurozone countries. Because of the single currency, the ECB does not have to factor exchange rates into its policy decisions, leaving interest rates as its primary policy tool.

Who Are the Players in the FX Market?

The influence of the players in the FX market has shifted over the years. Traditionally, the most important players in the FX markets were importers and exporters of goods, trading currencies through banks. International trade was thus the primary driver of supply and demand for currencies. Trade still influences FX markets directly through commerce and indirectly through market movements that follow official international trade and investment flow data. But over time, the importance of trade has waned as financial investors have become increasingly active in FX markets.

The driving force behind this transition to a market dominated by investors was the search for profitable investment opportunities across borders. For example, a British investor buying equities in the U.S. takes on currency risk by holding shares in U.S. dollars. He may want to hedge this risk in an attempt to insulate profits from the impact of any adverse movements in the exchange rate.

In recent years, investors discovered currencies as a distinct asset class and potentially an additional source of income. Lower returns on traditional asset classes, such as equities and bonds, and a mismatch between the assets and future liabilities of pension funds led investors to seek new, uncorrelated sources of return. Currencies can offer not only diversification but also the potential for additional returns due to inefficiencies in the FX market.

Financial institutions have become the biggest players in the FX market. Interbank business accounts for about half of FX turnover, according to the Bank for International Settlements, but the greatest growth in participation comes from other financial institutions; including insurance companies, pension funds, hedge funds, asset managers and, most of all, central banks.

Approaches to Investing in Currencies

Although currencies are considered an asset class, an investor cannot simply invest in a currency. An investment requires taking a view on the value of one currency relative to another, such as the U.S. dollar relative to the euro.

Many global companies and investment management firms use the FX markets to hedge their currency exposures. Investors seeking profits through the FX markets can use different approaches to investing in currencies. Among these, the “carry trade” has made the most headlines. Also known as forward rate bias, the carry approach seeks to take advantage of different interest rate levels in two countries. In its simplest form, an investor borrows money in a low-interest rate currency and invests in a higher yielding currency, profiting from the difference in interest rates. The carry trade exposes investors to the risk that exchange rates could move adversely and unexpectedly, reducing or even eliminating the potential for profits.

The so-called fundamental approach is one of the most common approaches in the FX market. Companies and investors often analyze fundamentals, such as economic growth, economic policy and national budget deficits and surpluses, to try to identify the fair value of a currency and anticipate how the exchange rate will move. By taking direct exposure to currencies this way, investors take the risk of losing part or all of their investment if their analysis is not correct.

Conclusion

Currencies, the world’s oldest financial instruments, are an integral part of modern trade and investment. Today, most major currencies have free-floating exchange rates, which help boost financial stability in the increasingly global economy. Globalization in trade and services laid the foundation for the modern currency markets, but profit-seeking investors have since become the dominant force in the FX market. There are several paths to potential profits in the FX market, including the carry trade and direct exposure to currency movements. Now regarded as a distinct asset class, currencies are among the world’s most liquid and high-volume markets.

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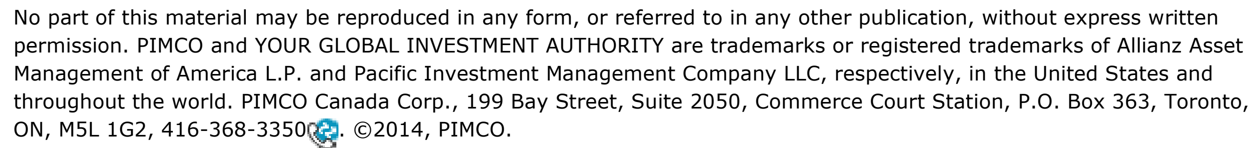

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