Lecture №4

Types of Exchange Arrangements
Rates of Exchange

The major part of speculations is executed on the Forex market.

Being a global market, Forex does not have a fixed place of trading and represents a huge army of traders connected by communication channels. Trading is executed by means of phones and computers at the same time all over the world. Consequently, trading does not stop because there are always people or organizations who want to buy or sell currencies. Being an interbank market, Forex is in the lead among all others segments of the currency exchange market by volume of deals. It is conversion operations (exchange deals of some amount of monetary unit of one country for the currency of another country at the exchange rate on a certain date) with their high profitability in comparison with deposit-credit operations (short-term operations of allocation and attracting missing funds in international currencies for a specified time with fixed interest) attract the most important traders. Almost all trading instruments are traded on Forex but the most popular are USD, EUR, JPY, GBP and CHF, which is why they are called “major currencies.” These currencies compose the major currency pairs of the Forex market – EUR/USD, GBP/USD, USD/CHF, and USD/JPY.

The exchange rate of one currency against another on the Forex market is formed as a result of bid and asks. The process of exchange rate fixing is called price quotations. These can be either direct or reversal.

A **direct quotation** is the price expression of a foreign currency through the national one. Most of the currency exchange rates are direct quotation of the US Dollar to currencies of different countries.

Example:

USD/RUR – 33.70: this means that 1 US Dollar equals to 33.70 Rubles;

USD/UAH – 6.05: this means that 1 US Dollar equals to 6 hryvnia 5 kopeck;

USD/CHF – 1.2350: this means that 1 US Dollar equals to 1.2350 Swiss Franc.

A **reversal quotation** is the price expression of the national currency through a foreign one. Historically, the English and Irish pounds, Euro, Australian and New Zealand dollar, among others, have reversal quotations.

For instance, the quotation EUR/USD – 1.2570 means that 1 Euro equals to 1.2570 US Dollars, and if you see the quotation GBP/USD – 1.8420, then in this case 1 English pound equals to 1.8420 US Dollars, etc.

Moreover, there exists such a concept as a **cross quotation**. It refers to exchange quotations where USD is not the base currency or not a currency of the pair – EUR/JPY, GBP/CHF, EUR/GBP, and so forth.

There are also quotations by time of execution, i.e. settlement date. A **settlement date** is a date when a real exchange of funds by way of bought currency receipt and sold currency delivery to the agent of a deal happens. In this case the quotations can be with settlement date **"spot"** and **"forward."** All current market quotations are **"spot"** prices. The **"spot"** quotation maturity date is the second working day after the "operation date." For instance, if the operation was executed on Tuesday, then the settlement date would be Thursday, but if a deal was executed on Friday, then settling would be on the Tuesday of the following week. A "**forward**" quotation settlement date would be in three or more working days after the date of a deal execution. We will discuss "forward" quotations and deals in details in the future lectures of this course.

It is important to remember that the currency which is the first in a pair is called a **base currency,** or **quoted currency**, the value of which is presented, and the second one is **evaluation currency,** or **currency of a deal** (it is the unit in which the base currency is evaluated).

Let us consider the currency pair USD/RUR. USD is the base currency and RUR is the currency of the deal. The value of the US Dollar is Ruble-denominated.

Base currency Quoted currency

GBP/USD

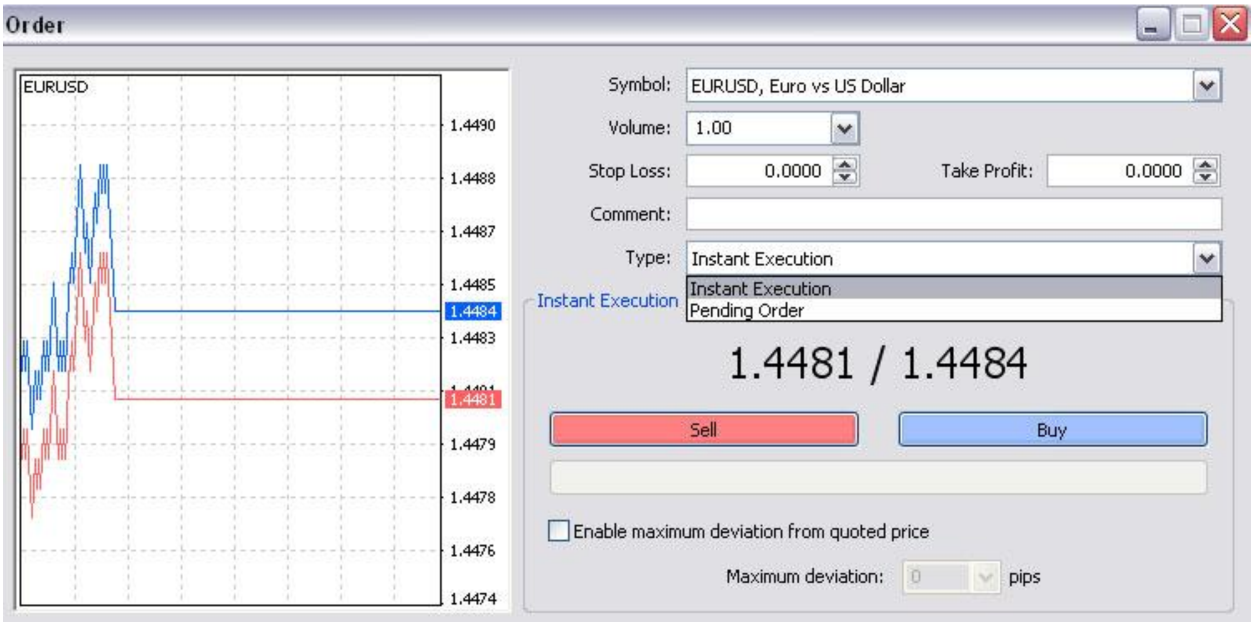
Base currency Quoted currency

USD/RUR

Base currency Quoted currency

EUR/USD

What is important to remember in this case? Regardless of the currency pair chosen for a deal, **it is always the base currency that is being sold or bought; it is the asset**. That is why if you want to open a EUR/USD order (Picture1), you should understand that you will buy or sell EUR. Many people think that if they sold Euro versus US Dollar it is the same as if they sold US Dollar versus Euro. In general, it is a fair point, but it can lead to unwanted mistakes when opening or closing a position.



Picture1.

You should remember that the base currency is the one being sold or bought, the currency which appears first in the currency pair.

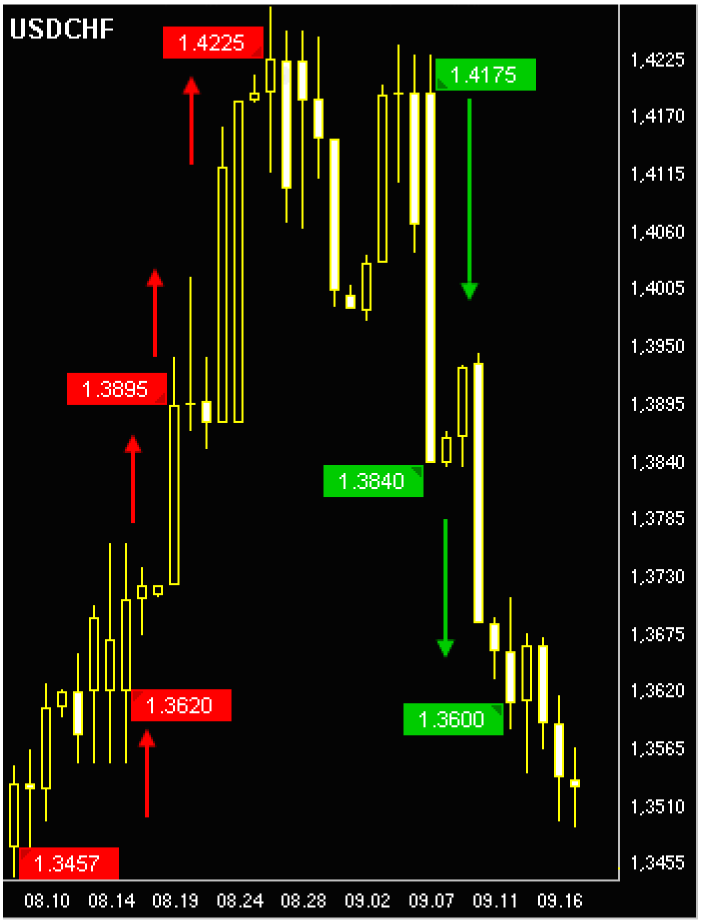
The notion of base currencies will be useful also when considering cases of price movement plotting. The value of one unit of a base currency is changing versus the evaluated one. For instance, the currency pair EUR/USD quotation will be plotted as the value of 1 EUR for some amount of US Dollars. If the Euro's price is rising, i.e. the absolute value of the US Dollar is increasing, then consequently, the Euro goes up, or "strengthens" and the chart moves up. If the Euro's price is falling (the US Dollar absolute value is decreasing), it means the Euro becomes cheaper and the chart moves down.

Considering the currency pair USD/CHF then, all that was said above is true for the USD. In this case the US Dollar is rising and the chart is moving up as well, if the absolute value of the Swiss Franc is increasing. The USD is falling and the chart is moving down when the absolute value of the Swiss Franc is decreasing.

It means that if a chart moves up, the base currency rises in price; if the chart moves down, then the base currency becomes cheaper.

Picture 2.

Picture 2 shows an example of the rising and falling of the Euro versus the US Dollar. On the left side we can see that the absolute value of the US Dollar is increasing. It means that for 1 Euro one pays more US Dollars. On the right side it is decreasing, which means that the Euro is becoming cheaper.



Picture 3.

There is an example of the rising and falling of the US Dollar versus the Swiss franc in picture 3. In this case the base currency is the dollar and chart reflects the price movement of 1 US Dollar versus the Swiss franc.

On the currency market it is common to display quotations in five-digit numbers. For instance, EUR/USD – 1.2724, USD/CHF – 1.2045, USD/JPY – 106.74, GBP/USD – 1.8560, etc. The last digit reflects points. The smallest possible quotation change is called a change in one point. A change of USD/JPY from 106.74 to 106.75, or GBP/USD from 1.8560 to 1.8561 shows that the Yen became cheaper versus the US Dollar in 1 point, while the pound increased in price 1 point.

The major market-makers, as mentioned earlier, are commercial banks, central banks, brokerage companies, private persons, investment foundations and exchange markets. The basic market quotations are formed on the basis of demand and supply as a result of major market-makers interaction (banks, investment foundations, etc.).

Every market-maker in every single deal acts as a seller or buyer. Banks and financial companies trading market always give bilateral quotations. The left side of the quotation is called **bid**, and right one is **ask**. If you are going to sell a base currency, you act as a seller and would make a deal by the **bid** price. If you decided to buy one, then you are the client and the order is opened at the **ask** price. The **bid** price is always lower than the **ask** price because the dealer is obliged to buy the base currency at the **bid** price and sell it at the **ask** price. The difference between the buying and selling prices is called **spread** and is often the dealer's main basis of income.

Let us consider some examples. Please pay attention to the situation given below, which is similar to an exchange office. If you are going to sell a traded currency then it will be bought There is an example of the rising and falling of the US Dollar versus the Swiss franc in picture 3. In this case the base currency is the dollar and chart reflects the price movement of 1 US Dollar versus the Swiss franc.

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Spread – ask – bid

SuperForex provides a fixed spread of 3 points to all major currency pairs.

	bid	ask	Spread
EUR/USD	1.2725	1.2728	0.0003 (3 points)
USD/CHF	1.2045	1.2048	0.0003 (3 points)
USD/JPY	106.75	106.78	0.03 (3 points)
GBP/USD	1.8560	1.8563	0.0003 (3 points)

By 'market-maker work on the Forex market' one usually means qualitative or quantitative changes of its currency position. A currency position is the correlation of requirements and reliabilities by the quoted currencies on the market. It can be open or closed. A closed currency position supposes coincidence of requirements and reliabilities by every currency pair. It means that the market-maker does not buy or sell anything at the moment. An open currency position appears when there is a divergence of requirements and reliabilities by any currency and can be **long** or **short.** We are not going to enter into details about the origin of these notions, as they arose from the peculiarities of bankers' discount and bank balance sheets, just remember that **buying a base currency is a long position while selling it is a short position**. The principle of "buy cheaper, sell higher" applies to this logic. Usually one buys a base currency hoping it would increase in price versus the evaluated currency. Opening a long position happens when buying, while the closing is the reversal of this operation - the sale of the currency.

The initial selling of a base currency is the basis of the short position, the idea being "sell higher, buy cheaper." The sequence of processes of buying and selling is reversed. If the dealer supposes that the quotation of some currency will fall, he/she sells it. When a quotation falls s/he will buy it cheaper, deriving profit from difference between the buying and selling prices. The opening of a short position happens by selling the currency, closing it happens with buying it.

Simplified scheme of short and long orders balance:

1. Scheme of order balance with initially opening a long position. SuperForex has reduced the lot volume to 10000 which allows trading with a minimal deposit of just 1 USD.

		bid	ask
Quotation	EUR/USD	1.2725	1.2728

Opening a long position would be buying EUR (volume 10000 Euro) at the price 1.2728 USD for 1 Euro.

Balance of long position:

+10000 EUR	-12728 USD

Closing of a long position is selling the EUR (volume 10000 Euro) at the price 1.2750

Balance changes

-10000 EUR	+12750 USD

Final balance

+10000 EUR -10000 EUR	-12728 USD +12750 USD
0	+22 USD

1. Scheme of order balance when you start with a short position.

		bid	ask
Quotation	EUR/USD	1.2725	1.2728

Opening a short position – sell EUR (volume 10000 Euro) at the price 1.2725 USD for 1 Euro.

Balance of short position:

+10000 EUR	-12728 USD

Closing of a short position is the reversal buy-out EUR (volume 10000 Euro) at the price 1.2728.

Balance changes

-10000 EUR	+12728 USD

Final balance

-10000 EUR +10000 EUR	+12725 USD -12728 USD
0	-3 USD

Useful information for SFX MetaTrader 4 users:

The Forex market is an interbank market, so the main sources of quotations are banks market-makers (banks which “make” the market). Level-sensitive pricing occurs on the basis of their quotations. These banks are interacting actively with markets not only by customers’ requests but also by carrying out their own strategies.

These quotations enter specialized informational systems (Reuters, Bloomberg, Tenfor, DBC, etc.), and then go all over the world – to clients of informational systems (back to banks, individuals and corporate bodies and everybody who is connected to the systems).

Test Questions

1. What is the base currency in a pair? Give an example of a basic asset from your everyday life.
2. What is a spread?
3. What quotation (Bid or Ask) does the trader buy/sell currencies by?
4. What market participant conducts the buying/selling in a foreign exchange market operation?
5. Quotations were sequentially fixed during the day for the currency pair USD/JPY – 111.25, 111.50, 112.40, and 113.00. In what direction did the price chart of this currency pair move? Which currency of this pair increased in price and which one decreased?
6. A market participant decided to open a long currency pair GBP/USD position, which was quoted by – 1.8560 – 1.8565. Indicate what price position was opened and draw the balance scheme of that position.
7. Check if there is any mistake in the given below table and count the spread:

	bid	ask	Spread
EUR/USD	1.2843	1.2849	
USD/CHF	1.2141	1.2152	
USD/JPY	106.98	107.04	
GBP/USD	1.8695	1.8685	

8. Open a position on any currency pair and give a short description of this process. Draw the balance scheme of the position opened.