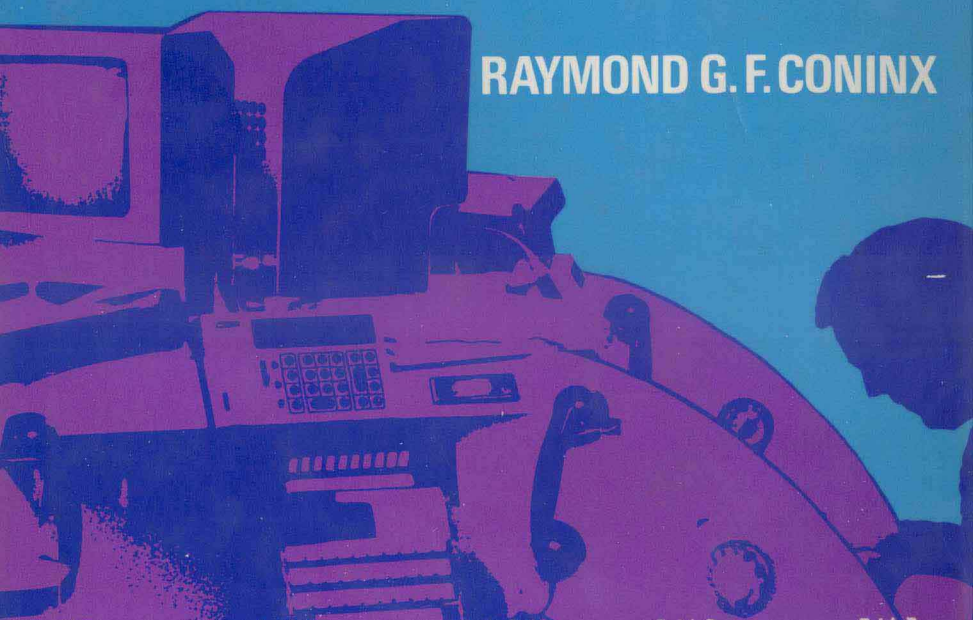


REVISED EDITION

Foreign Exchange Today

RAYMOND G. F. CONINX



SPOT	1MO	2MO	3MO	6MO
7384/87	27/22	50/40	81/71	175/155
3175-85	43-33	89-79	143-133	305-290
4150/60	75/65	145/135	220/210	400/390
8950-70	230/250	445/465	660/680	1260/13
450/65	75/65	135/125	187/177	289/279
7,50/70	680/730	14/16	22/24	44/47
915-25	870/900	1370/14	1770/18	2260/10
757-67	400/450	700/750	950/10	1450/50

Foreign Exchange Today

To
Mary, Jonathan, Fiona and Jeremy

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REVISED EDITION

RAYMOND G. F. CONINX

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Preface to the first edition

Over the years the thought of writing an introduction to foreign exchange crossed my mind on a number of occasions. I postponed the decision to put my ideas on paper time and time again, as interest in the subject seemed to be limited to professional foreign exchange dealers, treasurers of multi-national corporations and a few academics. The fact that Paul Einzig had covered the theory of the foreign exchanges in numerous works also provided me with a ready excuse for not trying to improve on perfection.

The advent of floating exchange rates a few years ago, and the frequent and continuing currency crises, have, however, given me the incentive to marshal my thoughts on the subject. The knowledge that foreign exchange has become of vital concern to all organizations involved in international finance is, to say the least, a great encouragement. Even experts who, in the past, would have busied themselves with more esoteric financial matters have taken up the study of foreign exchange.

As with any topic of current interest, books and articles appear almost daily analysing particular aspects of the currency markets and their impact on business decisions. Earnest endeavours are being made to find a universally applicable solution to the problems which currency exposures create for treasurers and accountants. Suggestions abound: cash management programmes with or without netting, 'off the peg' or 'tailor-made' forecasting models, accounting methods, and many others. The wealth of financial wisdom which is being offered to the commercial practitioner must leave him in a state of shock, and often no wiser than he was before. This is not surprising as it seems unlikely that there will be two companies with the same *modus operandi*, range

PREFACE

of products, capital base or business environment. As a result the excellent advice offered cannot be put into practice because it does not fit the specific situation.

Only the main risk-takers, the commercial companies and their executives, are in a position to decide which foreign exchange techniques are appropriate for their particular overall strategy. In *Foreign Exchange Today* I intend to give the commercial user an outline of current foreign exchange practices and some indication of how the professional dealers in the banks think, and put their thinking into practice. It would be foolish to suggest that all dealers act or react in the same way, but usually there is a degree of consensus which may not be apparent at the time. This background knowledge may help the 'outsider' to understand foreign exchange movements that at first sight seem opposed to common sense.

Chapters 1 to 6 of the book deal with the origins and recent history of the foreign exchange markets, important theoretical definitions and the factors which influence foreign exchange rates. Chapters 7 to 12 concentrate on the practical aspects of foreign exchange techniques, accounting procedures and foreign exchange rate forecasting.

I would like to emphasize again that it was never my intention to construct a set of solutions covering every eventuality. Nevertheless, I hope that after reading this book the 'foreign language' of the trade will seem less forbidding than before. I have in fact deliberately avoided the use of some contemporary jargon, which confounds even the professionals.

As current exchange rates date very quickly, fictional rates bearing some resemblance to identifiable currencies have been employed in the theoretical examples (*see* Appendix A, p. 153).

In the process of simplifying a subject as complex as foreign exchange, I have had to exclude some, to my mind, superfluous events, theories and practices which other observers may believe to be of prime importance. For this I apologize.

October 1977

R.G.F.C.

Preface to the revised edition

In foreign exchange chronology, 1977 seems light years ago. Much has changed on the international monetary scene, although basically the old problems of inflation and currency disequilibria are still with us.

The action-packed years 1978 and 1979 saw the near-collapse of the world's monetary system in late 1978, the reincarnation of the European Snake as the European Monetary System, the dramatic recovery of sterling, particularly against the US dollar, and on 23 October 1979 the total abolition of exchange controls in the United Kingdom. As most of these events are milestones in the history of foreign exchange, I have brought up to date Chapter 3 dealing with the period 1967 until the present day.

The mechanics of foreign exchange remain, however, much the same, and hence I have only made some marginal changes to the chapters explaining the arithmetic and the technicalities of currency dealing.

If anything, foreign exchange has now assumed even greater importance in international finance and most commercial organizations are directly affected by gyrating currency rates. With political uncertainty in many parts of the world and the escalating cost of energy—factors which affect some countries more than others—it appears highly likely that the 1980s will be a decade of turbulence in the money markets.

August 1980

R.G.F.C.

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1. *The origins of foreign exchange*

Unless they are connected with international business in their daily lives, the privileged inhabitants of the developed world come into contact with the foreign exchange phenomenon only when they go abroad for a change of scenery. 'Foreign exchange' for holiday-makers is embodied in the bank-notes of other countries, which somehow never look quite as respectable as their own national issue. If they are security-conscious they may even purchase travellers' cheques. Some travellers become adept currency dealers when they wake up to the fact that the conversion rates offered for their notes or cheques differ from place to place. They find that modest savings can be made by shopping around for the best rate. These minor discrepancies in the quoted rates may not spoil the fun of the sun-seeker, but they can make an international business deal a profitable venture or just a waste of time.

Foreign exchange and foreign exchange rates

It may be appropriate first to define our subject for readers who are not familiar with the theory of economics and foreign exchange. *Foreign exchange* is the act of converting the currency of one country into the currency of another. To execute this seemingly simple transaction a price or value is fixed for the currency which is being acquired or bought and this price is called the *foreign exchange rate*.

Foreign exchange transactions, entered into to settle international trade or financial operations, are rarely finalized in bank-notes. It would be cumbersome and also very risky to carry suitcases full of notes from one country to another (though in

recent years intrepid voyagers have smuggled large sums in banknotes across mountain passes in order to convert them into a more stable currency on the other side). We shall investigate the practicalities of currency settlements in Chapter 7—suffice it to mention here that exchange transactions are usually settled by transfers, from one account to another, in a foreign centre. This procedure is very similar to the one applied when money is transferred from one town to another within a country, for instance from Liverpool to London or from New York to San Francisco.

The demand, or lack of it, will decide the price or exchange rate for a currency. This practice is no different from that which operates in other markets. The greengrocer who goes to the early morning market will have to pay more for his fruit or vegetables if they are in short supply; similarly, a currency cheapens or gets dearer according to its availability or dearth. With some qualification, it could be said that money is just another commodity.

Direct and indirect quotations

In most of the world's money centres, exchange rates are quoted in terms of the national currency. For example, in New York the pound sterling will be quoted as being worth US \$1.70 or US \$2.00, or whatever the value of sterling is at the time. In other words, one pound equals 1.70 dollars, or whatever.

One of the vestiges of the time when sterling was of world-wide importance is the *indirect quotation system* of the London market, which values one pound in whole or part units of foreign currencies. Thus London quotes the value of sterling instead of the value of the foreign currency. This approach does not create problems for the experienced dealer, but it does mean that the casual user of the market has to divide a foreign currency amount by the exchange rate to find the sterling equivalent rather than using the simpler multiplication method of the *direct quotation system*.

With the rapid communications available to operators in the foreign exchange markets, the rates in different money centres will practically always be in equilibrium. The minor distortions which may show up from one centre to another, or for that matter one bank to another, will reflect the natural supply or demand situation, but usually they are of little consequence.

In principle, market forces will bring all rates to an equilibrium.

For instance, if one Deutsche Mark is worth 40 cents in New York, one dollar will be valued at DM 2.50 in Frankfurt, for one dollar divided by 40 cents equals 2.50. If local demand in New York, during the time that Europe and the United States can operate together, resulted in an appreciation of the Deutsche Mark to 41 cents, this would immediately be reflected in Frankfurt. Otherwise, smart operators would contact Germany to sell dollars at DM 2.50, and immediately sell the Deutsche Marks in New York, making a handsome profit in the process.

Some foreign exchange dealers make it their business to take advantage of such minor discrepancies. This activity is called *arbitrage*, and involves the buying and selling of a currency in different centres.

It should be made clear that a difference of 1 cent (between 0.40 and 0.41) would be a substantial discrepancy and a rare opportunity for an arbitrageur.

Bimetallism and the Gold Standards

Foreign exchange is not a new-fangled idea; it has existed in various guises since time immemorial. But in its current application it has really only existed since the end of the First World War. Before the First World War the external values of currencies were mainly determined by their worth as expressed in gold or silver. Furthermore, this worth was realizable only if there was no restriction placed on the convertibility of the national note issue into either of these precious metals.

Traditionally, a currency was considered to be fully convertible if notes and coinage could be freely exchanged for gold at the central bank's counters, but convertibility into gold ceased to be practicable after the First World War. The contemporary definition of a *convertible currency* would be one that can be used to purchase other currencies without let or hindrance from the monetary authorities. Some currencies when in the hands of non-residents can be fully convertible, while residents of the country are prohibited by regulations from acquiring foreign currencies. These currencies would then be said to have *limited convertibility* only.

Under a bimetallic standard it was normal for countries to set gold to silver ratios. This ratio was intended to stop speculative

movements from silver to gold and vice versa. Also it was useful for the general public to know that one gold coin equalled a certain number of silver ones; it was thus unnecessary for the individual to acquire the skills of an assayer. At the outset, the set ratios may have reflected the current availability balance between silver and gold, but the vagaries of mining and refining very rapidly produced imbalances. A gold discovery in the New World, or increased silver production, could tip the scales in favour of one or the other. Whenever a fundamental disequilibrium showed up, the cognoscenti of the time would hoard the coins struck in the more valuable metal, and before very long they disappeared completely from circulation.

The maxim attributed to Sir Thomas Gresham—Gresham's Law—very aptly describes a metal supply imbalance: 'Bad money drives out good.' This saying is still as valid today as it was in the sixteenth century; Sir Thomas was referring not just to supply imbalances but also to the fact that some rulers would deliberately debase the coinage struck by decreasing its precious metal content.

In spite of the spirited defence put up by its supporters, the bimetallic standard eventually gave way to the one-metal standard, or *monometallism*. By the beginning of the twentieth century countries like Great Britain and the United States had implemented the 'Full' or 'Specie Gold Standard' and this Gold Standard ruled supreme for several decades domestically and internationally. Countries with no access to mined gold, or too poor to take part in the extravaganza, adopted the Gold Exchange Standard. The countries on the Gold Exchange Standard simply kept the bulk of their foreign reserves in the currencies of countries which followed the 'Full Gold Standard'. The knowledge that the pound sterling and the dollar were literally worth their weight in gold allayed any fears about the absence of gold in their coffers. Any time a Gold Exchange Standard country needed the yellow metal badly it sold part of its hard currency holdings for gold. It then gained the additional benefit that surplus reserves could be invested in Treasury Bills or other suitable paper and earn interest, instead of incurring a safekeeping charge for bullion lying in some dank vault.

It is doubtful whether gold could ever again play a leading role

in the international payment system. It had its uses for a number of decades; it seemed to encourage monetary discipline until the First World War. But for practical purposes, for gold to keep pace with the expansion of the world's economies, it would have to be either mined in greater quantities or regularly upvalued, and neither prospect is very likely. In any case, to dig a hole in one place and put the extracted contents in another hole—or vault—is not a particularly productive activity, unless you happen to own a gold mine.

After the First World War most countries abandoned the Full Gold Standard by default: there was not enough gold around to back the inflated note circulations of the war-damaged economies. Most countries then adopted the Gold Exchange Standard, or a version of it. Some relied largely on gold but others preferred to keep the bulk of their reserves in countries which still settled official claims in gold. The term *hard currency* which before 1939 would have referred to a currency backed by large gold holdings now describes one with large foreign currency reserves.

In 1925 Great Britain tried to reintroduce an amended Gold Standard, the Gold Bullion Standard, but had to give up the attempt in 1931. The Gold Bullion Standard has been blamed for the General Strike of 1926 and the stagnation of the British economy during the years 1925–1931. Possibly it was not so much that gold had been reinstated but rather that the sterling price was too low and thus could not be sustained against speculative pressures from abroad.

The lesson that should have been learned from the British experiment was that national pride is not a rational basis for the fixing of a gold price or an exchange rate level. However, other countries and their governments consider their currencies equally sacrosanct.

In spite of the Gold Exchange Standard, the inter-war years were marred by a number of competitive devaluations—at least they were interpreted by others to have been made for competitive reasons. To ensure that there would be peace on the economic front after the war was over, the nations of the free world met at Bretton Woods in 1944 to try to put the international monetary system to rights.

2. From Bretton Woods to the 1967 sterling devaluation

It is often said that experience cannot be taught. Though we may agree wholeheartedly with this statement, it is also true that even second-hand experience is better than none. Very few of today's Stock Exchange members lived and worked through the Great Crash of 1929, but one would hope that they have read about it and assimilated the underlying causes of this, in retrospect, salutary occurrence.

Unfortunately, apprentice foreign exchange dealers do not as a rule undergo a period of formal training in their profession. Usually, they are chosen because they show aptitude in dealing. Whatever knowledge they gain afterwards is passed on to them verbally in a piecemeal fashion. Experience is obtained through repeatedly making mistakes, hopefully only minor ones which do not cost the bank a fortune. This hit-and-miss method of training dealers is then supposed to produce top-quality money experts. No wonder only a few make the grade. Foreign exchange executives in commercial companies are usually much better qualified, but they do not have dealing experience and have only a limited knowledge of monetary history.

The professional dealer and the commercial operator both have much to gain by the study of economic and monetary history. They will find this background knowledge invaluable when they come across a situation which is a carbon copy of a past event. Their second-hand experience may not produce larger profits, but it may help to avoid substantial losses.