# EXCHANGE RATE ECONOMICS – LECTURE 1
# INTRODUCTION TO THE FX MARKET

## *A. Institutions and Trading Protocols*

***Trading venues**

**5 years ago: interbank and traditional brokers**
**each ½**
**today: interbank 1/3; traditional brokers 1/6;**
**electronic brokers ½**

***Counterparties**

**Customer trades 1/3**
**Interbank trades 2/3**
**both today and 5 years ago**

***Conventional spreads ("pips")**

| | |
|---|---|
| **USD/GBP** | **5** |
| **DEM/USD** | **3** |
| **JPY/USD** | **3** |
| **CHF/USD** | **5** |

**adopted by most "to maintain an equitable & reciprocal trading relationship"**
**important for reputation**
**"Dealers make the majority of their profit on rate movement, not spread."**

***Deviations from conventional spread**

1. **Thin & hectic market**
2. **Before & after major news release**
3. **Increased market volatility**

***What gives dominant players advantage?**

1. **Large customer base**
2. **Better information**

***How much time is required for full adjustment to macro announcements?**

**1/3 say < 10 seconds**
**2/5 say < 1 minute**

**price adjusts quickly to new info.**

***What news matters most?**

**Today: unemployment, interest rates, inflation**

**5 yrs ago: trade deficit, interest rates, unemployment**

**so expect parameter instability in "fundamentals" models of exchange rates**

**Reference: Cheung & Chinn, "Currency Traders & Exchange Rate Dynamics,"** ***JIMF*****, 2001 or** http://econ.ucsc.edu/

*B. “New Electronic Trading Systems in Foreign Exchange Markets*

***2 main groups of participants: customers and dealers**

***customers**

**end-users like multinational firms, central banks, hedge funds,...**

**traditionally trade with dealers and not with each other**

**trades are private info to dealers**

***dealers**

**trade with customers**

**trade with each other in interbank market**

**low transparency**

***interbank market**

**traditionally direct telephone trading**

**Reuters Dealing 2000-1 in 1987 substitute for telephone**

**Voice brokers and private networks with speaker boxes in 1960s**

**until early 1990s trade split in half between direct trades and voice brokers**

**interbank trades a large multiple of customer-dealer trades due to “hot-potato” passing of positions**

***electronic brokers for interbank trading**

**Reuters Dealing 2000-2, April 1992**
**Minex, April 1993**
**EBS, September 1993**
**EBS/Minex December 1995**

**Limit orders with price/time priority**

**Orders anonymous with identities revealed at trade**

**Lower costs and greater transparency**
**Market orders pay $25**

**Market share has climbed steadily**

***internet trading for customer trades**

**Deal4Free, May 1996 & OANDA, March 2001 are examples of nonbank internet sites**

**Operate as crossing networks that obtain prices for the interbank market rather than operate as electronic brokers**
**Site is counterparty to all trades**

**FX Connect, August 1996 & Currenex, April 2000 are examples of bank sites**
**Customers request quotes from several banks**

**Increases competition and lowers costs for customers**

**Reference: Rime, "New Electronic Trading Systems in Foreign Exchange Markets" in *New Economy Handbook*, D.C. Jones, ed., Academic Press, 2003 (no pdf file available)**