FOREX

On-Line Manual
For Successful Trading

CONTENTS

CHAPTER 1
Introduction

1.1. Foreign Exchange as a Financial Market

Currency exchange is very attractive for both the corporate and individual traders who make money on the Forex - a special financial market assigned for the foreign exchange. The following features make this market different in compare to all other sectors of the world financial system:

- heightened sensibility to a large and continuously changing number of factors;
- accessibility to all traders in the major currencies;
- guaranteed quantity and liquidity of the major currencies;
- increased consideration for several currencies, round-the clock business hours which enable traders to deal after normal hours or during national holidays in their country finding markets abroad open and
- extremely high efficiency relative to other financial markets.

This goal of this manual is to introduce beginning traders to all the essential aspects of foreign exchange in a practical manner and to be a source of best answers on the typical questions as why are currencies being traded, who are the traders, what currencies do they trade, what makes rates move, what instruments are used for the trade, how a currency behavior can be forecasted and where the pertinent information may be obtained from. Mastering the content of an appropriate section the user will be able to make his/her own decisions, test them, and ultimately use recommended tools and approaches for his/her own benefit.

1.2. Foreign Exchange in a Historical Perspective

Currency trading has a long history and can be traced back to the ancient Middle East and Middle Ages when foreign exchange started to take shape after the international merchant bankers devised bills of exchange, which were transferable third-party payments that allowed flexibility and growth in foreign exchange dealings.

The modern foreign exchange market characterized by the consequent periods of increased volatility and relative stability formed itself in the twentieth century. By the mid-1930s London became to be the leading center for foreign exchange and the British pound served as the currency to trade and to keep as a reserve currency. Because in the old times foreign exchange was traded on the telex machines, or cable, the pound has generally the nickname “cable”. In 1930, the Bank for International Settlements was established in Basel, Switzerland, to oversee the financial efforts of the newly independent countries, emerged after the World War I, and to provide monetary relief to countries experiencing temporary balance of payments difficulties.

After the World War II, where the British economy was destroyed and the United States was the only country unscarred by war, U.S. dollar became the prominent currency of the entire globe. Nowadays, currencies all over the world are generally quoted against the U.S. dollar.

1.3. Main Stages of Recent Foreign Exchange Development

The main phases of the further development of the Forex in modern times were:

- signing of the Bretton Woods Accord;
- constitution of the international monetary fund (IMF);
- emergency of the free-floating foreign exchange markets;
- creation of currency reserves;
- constitution of the European Monetary Union and the European Monetary Cooperation Fund;
- introduction of the Euro as a currency.

The Bretton Woods Accord was signed in July 1944 by the United States, Great Britain, and France which agreed to make the currency market stable, particularly due to governmental controls on currency values. In order to implement it, two major goals were: emphasized: to provide the pegging (backing of prices) of currencies and to organize the International Monetary Fund (IMF).

In accordance to the Bretton Woods Accord, the major trading currencies were pegged to the U.S. dollar in the sense that they were allowed to fluctuate only one percent on either side of that rate. When a currency exceeded this range, marked by intervention points, the central bank in charge had to buy it or sell it, and thus bring it back into range. In turn, the U.S. dollar was pegged to gold at $35 per ounce. Thus, the U.S. dollar became the world's reserve currency.

The purpose of IMF is to consult with one another to maintain a stable system of buying and selling the currencies, so that payments in foreign money can take place between countries smoothly and timely.

The IMF lends money to members who have trouble meeting financial obligations to other members, on the condition that they undertake economic reforms to eliminate these difficulties for their own good and the good of the entire membership. In total the main tasks of the IMF are:

- to promote international cooperation by providing the means for members to consult and collaborate on international monetary issues;
- to facilitate the growth of international trade and thus contribute to high levels of employment and real income among member nations;
- to promote stability of exchange rates and orderly exchange agreements, and [to] discourage competitive currency depreciation;
- to foster a multilateral system of international payments, and to seek the elimination of exchange restrictions that hinder the growth of world trade;
- to make financial resources available to members, on a temporary basis and with adequate safeguards, to permit them to correct payments imbalances without resorting to measures destructive to national and international prosperity.

To execute these goals the IMF uses such instruments as Reserve tranche which allows a member to draw on its own reserve asset quota at the time of payment, Credit tranche drawings and stand-by arrangements are the standard form of IMF loans, the compensatory financing facility extends financial help to countries with temporary problems generated by reductions in export revenues, the buffer stock financing facility which is geared toward assisting the stocking up on primary commodities in order to ensure price stability in a specific commodity and the extended facility designed to assist members with financial problems in amounts or for periods exceeding the scope of the other facilities.

Since 1978 free-floating of currencies were officially mandated by the International Monetary Fund. That is the currency may be traded by anybody and its value is a function of the current supply and demand forces in the market, and there are no specific intervention points that have to be observed. Of course, the Federal Reserve Bank irregularly intervenes to change the value of the U.S. dollar, but no specific levels are ever imposed. Naturally, free-floating currencies are in the heaviest trading demand. Free-floating is not the sine qua non condition for trading. Liquidity is also an indispensable condition.

A tool for people and corporations to protect investments in times of economic or political instability is currency reserves for international transactions. Immediately after the World War II the reserve currency worldwide was the U.S. dollar. Currently there are other reserve currencies: the euro and the Japanese yen. The portfolio of reserve currencies may change depending on specific international conditions, for instance it may include the Swiss franc.

The creation of the European Monetary Union was the result of a long and continuous series of post-World War II efforts aimed at creating closer economic cooperation among the capitalist European countries. The European Community (EC) commission's officially stated goals were to improve the inter-European economic cooperation, create a regional area of monetary stability, and act as "a pole of stability in world currency markets."

The first steps in this rebuilding were taken in 1950, when the European Payment Union was instituted to facilitate the inter-European settlements of international trade transactions. The purpose of the community was to promote inter-European trade in general, and to eliminate restrictions on the trade of coal and raw steel in particular.

In 1957, the Treaty of Rome established the European Economic Community, with the same signatories as the European Coal and Steel Community. The stated goal of the European Economic Community was to eliminate customs duties and any barriers against the transit of capital, services, and people among the member nations. The EC also started to raise common tariff barriers against outsiders.