PROFESSIONAL ENGLISH by M. Belogash

UNIT 10 FOREIGN EXCHANGE MARKET

10.1 Getting started.

Trade between countries involves the mutual exchange of different currencies (or, more usually, bank deposits denominated in different currencies). For funds to be transported from one country to another, they have to be converted from the currency of the country of origin into the currency of the country they are going to. The **foreign exchange market** is where this conversion takes place, so it is instrumental in moving funds between countries. Transactions conducted in the foreign exchange market determine the rates at which currencies are exchanged, which in turn determine the cost of purchasing foreign goods and financial assets.

Discuss the following points:

1. Why do you think exchange rates are highly volatile?
2. Does the exchange rate affect the economy and our daily lives? Why?
3. When the euro appreciates, are you more likely to drink California or French wine?

10.2 Look through the following vocabulary notes which will help you understand the text and discuss the topic.

mutual	взаимный, обоюдный, общий
currency	валюта, денежные знаки
to denominate	выражать, номинировать
foreign exchange	иностранная валюта
a foreign exchange market	валютный рынок
to be instrumental	служащий средством достижения
an exchange rate	валютный/обменный курс

volatile	неустойчивый, волатильный
volatility	неустойчивость, волатильность
the dollar, the euro, the yen	доллар, евро, иена
to appreciate appreciation	повышаться в цене повышение курса валюты
to depreciate depreciation	понижаться в цене понижение курса валюты
predominant	преобладающий, доминирующий
spot transaction	кассовая/наличная сделка
spot exchange rate	курс «спот»
forward transaction	срочная сделка
forward exchange rate	курс «форвард»
in the long run	в долгосрочной перспективе
in the short run	в краткосрочной перспективе
productivity	производительность
relative to	По сравнению, по соотношению, относительный касательно
a determinant	определяющий фактор, детерминант
preferences	предпочтения
reasoning	доводы, рассуждения
versus	по сравнению с
to lag behind	отставать, запаздывать
a response	ответная реакция, реагирование
a convention	условное обозначение
to exhibit	демонстрировать, проявлять
money supply	запас денежной массы
overshooting	уровень валютного курса, не соответствующий положению в экономике
a correspondent bank	корреспондирующий банк
a correspondent account	корреспондентский счет
to transfer ownership	передавать право собственности
a foreign exchange forecast	прогноз о валютных курсах
accurate	точный
to generate profits	формировать, генерировать прибыль

a country of origin	страна происхождения
to engage in	заниматься чем-либо
to rely on	полагаться на что-либо, кого-либо

10.3 Reading

Why Are Foreign Exchange Rates Important?

There are two kinds of exchange rate transactions. The predominant ones, called **spot transactions**, involve the immediate (two-day) exchange of bank deposits. **Forward transactions** involve the exchange of bank deposits at some specified future date. The **spot exchange rate** is the exchange rate for the spot transaction, and the **forward exchange rate** is the exchange rate for the forward transaction. When a currency increases in value, it experiences **appreciation**; when it falls in value and is worth fewer domestic units of money, it undergoes **depreciation**.

Exchange rates are important because they affect the relative price of domestic and foreign goods. The dollar price of French goods to an American is determined by the interaction of two factors: the price of French goods in the euro and the euro/dollar exchange rate. ***When a country's currency appreciates (rises in value relative to other countries), the country's goods abroad become more expensive and foreign goods in that country become cheaper (holding domestic prices constant in the two countries). Conversely, when a country's currency depreciates, its goods abroad become cheaper and foreign goods in that country become more expensive.***

Depreciation of a currency makes it easier for domestic manufacturers to sell goods abroad and makes foreign goods less competitive in domestic markets.

You cannot go to a centralized location to watch exchange rates being determined; currencies are not traded on exchanges such as the New York Stock Exchange. Instead, the foreign exchange market is organized as an over-the-counter market in which several hundred dealers (mostly banks) stand ready to buy and sell deposits

denominated in foreign currencies. Because these dealers are in constant contact, the market is very competitive; in effect, it functions no differently from a centralized market.

Another important point to make is that while banks, companies, and governments talk about buying and selling currencies in foreign exchange markets, they do not take a fistful of dollar bills and sell them for British pound notes. Rather, most trades involve the buying and selling of bank deposits denominated in different currencies. The volume of this market is colossal, exceeding $3 trillion per day. Trades in the foreign exchange market consist of transactions in excess of $1 million. We buy foreign currency in the retail market from dealers such as American Express or from banks. Because retail prices are higher than wholesale, when we buy foreign exchange, we obtain fewer units of foreign currency per dollar than banks.

Like the price of any good or asset in a free market, exchange rates are determined by the interaction of supply and demand. To simplify our analysis of exchange rates in a free market, we divide it into two parts. First, we examine how exchange rates are determined in the long run; then we use our knowledge of the determinants to help us understand how exchange rates are determined in the short run.

In the long run, four major factors affect the exchange rate: relative price levels, tariffs and quotas, preferences for domestic versus foreign goods, and productivity. We examine how each of these factors affects the exchange rate while holding the others constant. The basic reasoning proceeds along the following lines: anything that increases the demand for domestically produced goods relative to foreign traded goods tends to appreciate the domestic currency because domestic goods will continue to sell well even when the value of the domestic currency is higher. Similarly, anything that increases the demand for foreign goods relative to domestic goods tends to depreciate the domestic currency because domestic goods will continue to sell well only if the value of the domestic currency is lower.

Relative Price Levels In line with PPP theory, when prices of American goods rise (holding prices of foreign goods constant), the demand for American goods falls and the dollar tends to depreciate so that American goods can still sell well. By contrast, if prices of Japanese goods rise so that the relative prices of American goods fall, the demand for American goods increases, and the dollar tends to appreciate because the American goods will continue to sell well even with a higher value of the domestic currency. ***In the long run, a rise in a country's price level (relative to the foreign price level) causes its currency to depreciate, and a fall in the country's relative price level causes its currency to appreciate.***

Trade Barriers Barriers to free trade such as tariffs (taxes on imported goods) and quotas (restrictions on the quantity of foreign goods that can be imported) can affect the exchange rate. Increases in trade barriers and decreases of quotas increase the demand for domestic goods, and the domestic currency tends to appreciate because the domestic goods will still sell well even with a higher value of the domestic unit of currency. ***Increasing trade barriers cause a country's currency to appreciate in the long run.***

Preferences for Domestic Versus Foreign Goods ***Increased demand for a country's exports causes its currency to appreciate in the long run; conversely, increased demand for imports causes the domestic currency to depreciate.***

Productivity When productivity in a country rises, it tends to rise in its domestic sectors that produce traded goods rather than non-traded goods. Higher productivity, therefore, is associated with a decline in the price of domestically produced goods relative to foreign traded goods. As a result, the demand for domestic goods rises, and the productivity lags behind that of other countries, its traded goods become relatively more expensive, and the currency tends to depreciate. ***In the long run, as a country becomes more productive relative to other countries, its currency appreciates.***

The trick to figuring out what long-run effect a factor has on an exchange rate is to remember the following: ***If a factor increases the demand for domestic goods relative to foreign goods, the domestic currency will appreciate; if a factor decreases the relative demand for domestic goods, the domestic currency will depreciate.*** See how this works by explanation what happens to the exchange rate when any of the factors in Table 1 decreases rather than increases.

Table 1 Factors That Affect Exchange Rates in the Long Run

Factor	**Change in factor**	**Response of the Exchange Rate, *E****
Domestic price level**	↑	↓
Trade barriers**	↑	↑
Import demand	↑	↓
Export demand	↑	↑
Productivity**	↑	↑

***Units of foreign currency per dollar: ↑ indicates domestic currency appreciation; ↓ , depreciation.**

****Relative to other countries.**

***Note*: Only increases in the factors are shown; the effects of decreases in the variables on the exchange rate are the opposite of those indicated in the "Response" column.**

Our long-term theory of exchange rate behavior is summarized in Table 1. We use the convention that the exchange rate *E* is quoted so that an appreciation of the currency corresponds to a rise in the exchange rate. In the case of the United States, it means that we are quoting the exchange rate as units of foreign currency per dollar. Exchange rates can be quoted as units of domestic currency per foreign currency so that an appreciation of the domestic currency is portrayed as a fall in the exchange rate. The opposite convention is used in the text here, because it is more intuitive to think of an appreciation of the domestic currency as a rise in the exchange rate.

Exchange Rates in the Short Run Factors driving long-run changes in exchange rates move slowly over time. If we are to

understand why exchange rates exhibit such large changes from day to day, we must develop a theory of how current exchange rates (spot exchange rates) are determined in the short run. The key to understanding it is to recognize that an exchange rate is the price of domestic assets (bank deposits, bonds, equities, etc.,) denominated in the foreign currency. Because the exchange rate is the price of one assert in terms of another, the natural way to investigate the short-run determination of exchange rates is to use an asset market approach. However, the long-run determinants also play an important role in the short-run asset approach. The theory of asset demand suggests that the most important factor affecting the demand for domestic (dollar) assets and foreign (euro) assets is the expected return on these assets relative each other. The key point here is that the relative expected return on dollar assets is the same whether it is calculated by Francois in terms of euros or by Al in terms of dollars. Thus, as the relative expected return on the dollar assets increases, both foreigners and domestic residents respond in exactly the same way – both will want to hold more dollar assets and fewer foreign assets.

There are different approaches to analyzing the reasons for exchange rates to change. The most relevant conclusions can be the following:

- When domestic real interest rates rise, the domestic currency appreciates.
- When domestic interest rates rise due to an expected increase in inflation, the domestic currency depreciates.
- A higher domestic supply causes the domestic currency to depreciate.
- The exchange rate falls by more in the short run than it does in the long run when the money supply increases (exchange rate overshooting), which explains the high volatility of exchange rates.
- Because expected appreciation of the domestic currency affects the expected return on foreign deposits, expectations about the

price level, inflation, trade barriers, productivity, import demand, export demand, and the money supply play important roles in determining the exchange rate.

When expectations about any of these change, as they do, there will be an immediate effect on the expected return on foreign deposits and therefore on the exchange rate. Because expectations of all these variables change with just about every bit of news that appears, it is not surprising that the exchange rate is volatile.

10.4 Comprehension

10.4.1 Answer the questions using the active vocabulary and Unit 10 Glossary.

1. What is a spot transaction ?
2. What is a forward transaction?
3. Define the concepts of ‘appreciation’ and ‘depreciation’.
4. What happens to a country’s goods abroad when a country’s currency appreciates?
5. Why do you think currencies are not traded on exchanges?
6. Why do you think the foreign exchange market is very competitive?
7. How are exchange rates determined in the long-run ?
8. Why do you think a rise in a country’s price level causes its currency to depreciate?
9. What are the major factors that affect the exchange rate in the long-run?
10. What are the major factors that affect the exchange rate in the short-run?
11. What is the difference between the exchange rate is quoted in the U.S. and in the Russian Federation?
12. Why do exchange rates exhibit such large changes from day to day?
13. What approach is used to investigate the short-run determination of exchange rates?

14. What is exchange rate overshooting?
15. How do you explain the high volatility of exchange rates?
16. What do you think affects the expectations of all variables?
17. What causes the domestic currency to depreciate?
18. What happens to the domestic currency when domestic real interest rates rise?
19. What causes the domestic currency to appreciate?

10.4.2 Mark these statements T(true) or F(false) according to the information in the Text and Unit 10 Glossary. If they are false say why.

1. Forward transactions involve the immediate (two-day) exchange of bank deposits.
2. Spot transactions involve the exchange of bank deposits at some specified future date.
3. Depreciation of a currency makes it easier for domestic manufacturers to sell goods abroad.
4. Currencies are traded on exchanges and over the counter.
5. Trades in the foreign exchange market consist of transactions in excess of $1 trillion.
6. The foreign exchange market (FX, or currency market) is a global, worldwide-decentralized financial market for trading currencies.
7. The foreign exchange market is unique because of its huge trading volume representing the largest asset class in the world leading to high liquidity.
8. Long-run determinants don’t play an important role in the short-run asset approach.
9. The foreign exchange market is the most liquid financial market in the world.
10. Factors which affect exchange rates in the long-run are the same as factors which affect exchange rates in the short-run.

11. Exchange rates are always quoted as units of domestic currency per foreign currency.
12. Exchange rates are always quoted as units of foreign currency per domestic currency.
13. An exchange rate is the price of domestic assets (bank deposits, bonds, equities, etc.,) denominated in the foreign currency.
14. Fluctuations in exchange rates are usually caused by actual monetary flows as well as by expectations of changes in monetary flows caused by changes in GDP growth, inflation, interest rates, budget and trade deficits or surpluses, large cross-border M&A deals and other macroeconomic conditions.
15. The exchange rate falls by less in the short run than it does in the long run when the money supply increases.
16. Currencies are traded against one another.
17. The asset market model of exchange rate determination states that "the exchange rate between two currencies represents the price that just balances the relative supplies of, and demand for, assets denominated in those currencies."
18. When domestic interest rates rise due to an expected decrease in inflation, the domestic currency depreciates.
19. When domestic real interest rates rise, the domestic currency depreciates.

10.5 Language practice

10.5.1 Match the English terms in the left-hand column with the definition in the right-hand column.

1	Bid price	**A**	A deal with a value date greater than the spot value date.
2	Broker	**B**	The forward rate of a foreign exchange deal based on spot price plus forward discount/premium.
3	Cash	**C**	A market position where the client

			has sold a currency he does not already own.
4	Closed position	**D**	The highest price that the seller is offering for the particular currency at the moment.
5	Correspondent bank	**E**	The settlement of a transaction by receipt or tender of a financial instrument or currency.
6	Currency risk	**F**	the buying and selling of the currency where the settlement date is two business days forward.
7	Dealer	**G**	The potential loss that could be incurred from an adverse movement in exchange rates.
8	Delivery	**H**	A market position where the Client has bought a currency they previously did not own.
9	Depreciation	**I**	The foreign banks representative who regularly performs services for a bank which has no branch in the relevant centre.
10	Exchange rate risk	**J**	A market conducted directly between dealers and principals via a telephone and computer network rather than a regulated exchange trading floor.
11	Forward deal	**K**	The netted total exposure in a given currency.
12	Long	**L**	Normally refers to an exchange transaction contracted for settlement on the day the deal is struck.
13	Outright rate	**M**	A transaction that offsets the number of units in a previous open position.
14	Over the counter	**N**	An individual or firm acting as a principal, rather than as an agent, in the purchase and /or sale of securities.
15	Position	**O**	An agent, who executes orders to buy

			and sell currencies and related instruments either for a commission or on a spread.
16	Short	**P**	A fall in the value of a currency due to market forces.
17	Spot	**Q**	The possibility of an unfavorable change in exchange rates.

10.5.2 Complete the following texts using the suitable words or phrases from the box.

Text 1

A	debts and claims	E	trading in foreign currency
B	a long position	F	a wide variety of
C	floating exchange rates	G	adjust
D	total position	H	risk exposure

Exchange Risks

Foreign exchange dealing is, as its name implies, the exchange of the currency of one country for the currency of another. In an era of ____(1)____, dealing in foreign exchange can be risky. Banks typically employ ____(2)____ currency-hedging techniques to help shelter their own and their customers' currency ____(3)____. Banks ____(4)____ are themselves exposed to exchange risks, unless the ____(5)____ neutralize each other. Dealers continually ____(6)____ the bank position in dollars, yen, pounds and other foreign currencies. They try to avoid both having ____(7)____ and being short in any foreign currency. As long as the ____(8)____ balances there is no risk for the bank.

10.5.3 Complete the text. Replace the Russian words and phrases by the English equivalents

Exchange of Deposits

Банки крупнейших денежных центров headquartered in New York, London, Tokyo, and other ***финансовые столицы мира*** not only maintain large inventories of key ***иностранных валют***, but ***торгуют валютой друг с другом*** simply through an ***обмен депозитами***. For example, if a major U.S. bank needs to acquire pounds sterling, it can ***связаться со своим корреспондирующим банком*** in London and ask that bank ***поставить дополнительную сумму*** of sterling to the U.S. bank's correspondent account. In turn, the U.S. bank ***увеличит депозит, деноминированный в долларах*** held with it by the London bank. In this way ***деньги никогда не покидают страну*** of its origin; only deposits denominated in various currencies have their ownership transferred ***от одного держателя*** to the next.

10.5.4 Text for discussion.

a. Look up the dictionary or Unit 8 Glossary for the meaning and pronunciation of the following words and word-combinations and use them to discuss the problems outlined in the text.

The value of assets on the balance sheet; to engage in trading foreign exchange; forecasters; international banking; generate substantial profits; to make errors.

b. Briefly scan the text and outline the list of major points.

c. Read the text more carefully and comment on the following items:

- A country is always worse off when its currency is weak.
- A country is always better off when its currency is strong.
- The effect of foreign currency forecasts on a bank's profitability.

Profiting from Foreign exchange Forecasts

Managers of financial institutions care a great deal about what foreign exchange rates will be in the future because these rates affect the value of assets on their balance sheet that are denominated in foreign currencies. In addition, financial institutions often engage in trading foreign exchange, both for their own account and for their customers. Forecasts of future foreign exchange rates can thus have a big impact on their foreign exchange trading operations.

Managers of financial institutions obtain foreign exchange forecasts either by hiring their own staff economists to generate them or by purchasing forecasts from other financial institutions. In predicting foreign exchange movements, forecasters look at the factors mentioned in this unit. For example, if they expect domestic real interest rates to rise, they will predict that the domestic currency will appreciate; conversely, if they expect domestic inflation to increase, they will predict that the domestic currency will depreciate.

Managers of financial institutions, particularly those engaged in international banking, rely on foreign exchange forecasts to make decisions about which assets denominated in foreign currencies they should hold.

Accurate foreign exchange rate forecasts can thus help a financial institution manager generate substantial profits for the institution. Unfortunately, exchange rate forecasters are no more or less accurate than other economic forecasters, and they often make large errors.

10.6 Render the passage in English using the English equivalents of the italicized phrases given in Russian. Express the main idea of the passage in one sentence.

Торговля валютой **(forex trading)** происходит в виде *наличных* **(spot)** или *срочных* **(forward)** операций. Наличные валютные операции осуществляются *на условиях «спот»* **(on spot terms)**, что подразумевает расчет на второй рабочий день после

заключения сделки по курсу, зафиксированному в момент ее заключения. Если валюта *должна быть поставлена* **(must be delivered)** в день совершения сделки или на следующий день, то она относится к типу *«овернайт»* **(overnight)**. Этим два типа сделок *объединяются* **(are combined)** понятием «кассовые сделки».

Банки используют операции «спот» для поддержания минимально необходимых *рабочих остатков* **(working balances)** на счетах в иностранных банках *в целях* **(with the aim to)** *уменьшения* **(reduce)** *излишков* **(surpluses)** в одной валюте и покрытия потребностей в другой валюте. С их помощью банки *регулируют* **(adjust)** свою валютную позицию, *чтобы избежать* **(to avoid)** непокрытых остатков на счетах. Несмотря на короткий срок поставки иностранной валюты, *контрагенты* **(counterparts)** *несут валютный риск* **(are exposed to exchange risks)** и по этой сделке, так как в условиях *плавающих валютных курсов* **(floating exchange rates)** курс может сильно *колебаться* **(fluctuate)** и измениться даже за два рабочих дня.

Валютные сделки, *расчет по которым производится более чем через два рабочих дня* **(with the settlement in more than two working days)** после их заключения, и при этом *обуславливается* **(is fixed)** не только срок, но и сама сумма и сам курс. Называются срочными (форвардными).

В биржевых котировочных бюллетенях публикуется **(exchange quotations provide for)** курс для сделок «спот» и *премии или скидки* **(premiums or discounts)** для определения курса по сделкам «форвард» на разные сроки. Если валюта по сделке «форвард» котируется дороже, чем при немедленной поставке на условиях «спот», то она котируется с премией. Скидка или дисконт означает *обратное* **(the opposite)**, *срочный курс, в котором учтена премия или скидка* **(a forward rate with a premium or a discount)**, именуется курсом «аутрайт». При премии валюта на срок дороже, чем наличный курс, при скидке –

дешевле. Имея *значение* **(the value)** премии или дисконта, вы вычисляете курс «аутрайт».

Срочные сделки *могут подразделяться* на **(can be categorized into)** сделки с «аутрайтом» - с условием поставки валюты *на определенную дату* **(on a certain date),** и сделки с «опционом» - с условием нефиксированной поставки. Одна из сторон по опционной сделке имеет право выбирать для себя наиболее выгодные условия исполнения обязательств. За это право вторая сторона получает премию. Целью этих сделок является *страхование* **(hedging)** поступлений и платежей в валюте *от валютного риска* **(from exchange risks)**. К срочным относятся также сделки типа *«своп»* **(swap)**, представляющие собой комбинацию операций «спот» и простой «форвард». Эти операции удобны для банков тем, что они не создают *открытой позиции* **(uncovered position)** (покупка покрывается продажей), временно обеспечивает необходимой валютой без риска, связанного с *колебаниями курса* **(exchange rate fluctuations)**.