

4.1: The Forex- Participants and Objectives

Learning objective

1. Learn who participates in foreign exchange markets and why.

The foreign exchange market (Forex) is not a market like the New York Stock Exchange, where daily trades of stock are conducted in a central location. Instead, the Forex refers to the activities of major international banks that engage in currency trading. These banks act as intermediaries between the true buyers and sellers of currencies (i.e., governments, businesses, and individuals). These banks will hold foreign currency deposits and stand ready to exchange these for domestic currency upon demand. The exchange rate (ER) will be determined independently by each bank but will essentially be determined by supply and demand in the market. In other words, the bank sets the exchange rate at each moment to equalize its supply of foreign currency with the market demand. Each bank makes money by collecting a transactions fee for its “exchange services.”

It is useful to categorize two distinct groups of participants in the Forex, those whose transactions are recorded on the current account (importers and exporters) and those whose transactions are recorded on the financial account (investors).

Importers and Exporters

Anyone who imports or exports goods and services will need to exchange currencies to make the transactions. This includes tourists who travel abroad; their transactions would appear as services in the current account. These businesses and individuals will engage in currency trades daily; however, these transactions are small in comparison to those made by investors.

International Investors, Banks, Arbitrageurs, and Others

Most of the daily currencies transactions are made by investors. These investors, be they investment companies, insurance companies, banks, or others, are making currency transactions to realize a greater return on their investments or holdings. Many of these companies are responsible for managing the savings of others. Pension plans and mutual funds buy and sell billions of dollars worth of assets daily. Banks, in the temporary possession of the deposits of others, do the same. Insurance companies manage large portfolios that act as their capital to be used to pay off claims on accidents, casualties, and deaths. More and more of these companies look internationally to make the most of their investments.

It is estimated by the Bank of International Settlements that over \$3 trillion (or \$3,000 billion) worth of currency is traded every day. Only about \$60 to \$100 billion of trade in goods and services takes place daily worldwide. This suggests that many of the currency exchanges are done by international investors rather than importers and exporters.

Investment Objectives

Investors generally have three broad concerns when an investment is made. They care about how much money the investment will earn over time, they care about how risky the investment is, and they care about how liquid, or convertible, the asset is.

1. **Rate of return (RoR).** The percentage change in the value of an asset over some period.

Investors purchase assets as a way of saving for the future. Anytime an asset is purchased, the purchaser is forgoing current consumption for future consumption. To make such a transaction worthwhile the investors hope (sometimes expect) to have more money for future consumption than the amount they give up in the present. Thus investors would like to have as high a rate of return on their investments as possible.

Example 1: Suppose a Picasso painting is purchased in 1996 for \$500,000. One year later, the painting is resold for \$600,000. The rate of return is calculated as

Example 2: \$1,000 is placed in a savings account for one year at an annual interest rate of 10 percent. The interest earned after one year is $\$1,000 \times 0.10 = \100 . Thus the value of the account after one year is \$1,100. The rate of return is

This means that the rate of return on a domestic interest-bearing account is merely the interest rate.

2. **Risk.** The second primary concern of investors is the riskiness of the assets. Generally, the greater the expected rate of return, the greater the risk. Invest in an oil wildcat endeavor and you might get a 1,000 percent return on your investment—that is, if you strike oil. The chances of doing so are likely to be very low, however. Thus a key concern of investors is how to manage the trade-off between risk and return.

3. **Liquidity.** Liquidity essentially means the speed with which assets can be converted to cash. Insurance companies need to have assets that are fairly liquid in the event that they need to pay out a large number of claims. Banks also need to be able to make payouts to their depositors, who may request their money back at any time.

Key takeaways

- Participants in the foreign exchange markets can be classified into traders and investors.
- Traders export or import goods and services whose transactions appear on the current account of the balance of payments.
- Investors purchase or sell assets whose transactions appear on the financial account of the balance of payments.
- The three main concerns for any investor are first to obtain a high rate of return, second to minimize the risk of default, and third to maintain an acceptable degree of liquidity.
- The rate of return on an asset is the percentage change in its value over a period.

exercise

1. **Jeopardy Questions.** As in the popular television game show, you are given an answer to a question and you must respond with the question. For example, if the answer is “a tax on imports,” then the correct question is “What is a tariff?”
 - This group enters the foreign exchange market to make transactions that will be recorded on the current account.
 - This group enters the foreign exchange market to make transactions that will be recorded on the financial account.
 - The percentage change in the value of an asset over some period.
 - The term used to describe the ease with which an asset can be converted to cash.
 - The term used to describe the possibility that an asset will not return what is originally expected.
 - A list of three main objectives for international investors.
 - The rate of return on a share of stock whose value rises during the year from \$5.50 per share to \$6.50 per share.
 - The rate of return on a commercial office building that was purchased one year ago for \$650,000 and sold today for \$600,000.

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