THE ECONOMICS OF FOREIGN EXCHANGE

HISTORY

GLOBALIZATION

Today, we live in an increasingly globalized word. The usual growth path for a business today always involves adding more dependencies on global supply-chains to ensure that their products and services are produced in the best country possible. To boost profits, you might want to cut manufacturing costs, and where else to get cheap components and parts from than China? Or maybe you want high quality parts from Germany to better satisfy your customers. Regardless, internationalizing supply chains is a very important near-compulsory step for every business to increase their growth. But this wasn't the case 100 years ago. "Imports" didn't exist. You either built the entire product locally or you couldn't. Trade was minimal and owning foreign products was a luxury. Maybe it's one of the reasons why the words "foreign goods" still commands so much respect today.

COMPARATIVE ADVANTAGE

Let's explain this concept through a simple case study of 2 countries, Germany and China. Germany is well-known for being a supplier of high quality, efficient and luxury parts. China on the other hand is well-known for being able to mass-produce cheap goods.

GERMANY

Let's say we asked Germany to produce iPhones. They could do it pretty easily because they already have all the infrastructure and technological expertise required to mass-produce them from their individual components without much difficulty. However, Germany has very expensive, limited labor and their government also has very stringent rules regarding industrial waste disposal. Add to this, it's not geographically close to the mass-suppliers of the components used in iPhones. According to educated estimates, iPhones built in Germany might cost as much as $\approx 4,000\$$.

CHINA

Now let's ask China to build luxury sports cars. They could probably do it. China mass produces a lot of EVs, but their manufacturing is a lot more targeted to more medium-quality mass manufacturing. China's labor force is much larger than Germany and is also comparatively lower-skilled. Their government also has much looser environmental regulations than Germany. A lot of the major NAND and other similar component suppliers are also in or near China. This makes it extremely well suited to mass manufacturing iPhones, but not luxury cars.

SYMBIOSIS

Germany *could* allocate some resources to building overpriced iPhones and China *could* allocate resourced to build *somewhat decent* luxury cars, but this requires a lot of research, exploration and budget to be allocated to these projects. But instead of doing that, they could just agree to focus on their strengths. Germany makes cars, and China makes phones. Now to ensure their citizens can enjoy both cheap phones and good quality cars, Germany over-produces and exports its cars to China, and China does the same with iPhones for Germany. Both countries get the best of both worlds.
dd ad
This is the because each country had a **comparative advantage** for the product they specialize it. However, note that this is an extremely simplified example. We have evolved past the barter system, trade is not done by putting up 100 iPhones for a car, but through currency. However, German manufacturers don't want Yuan and Chinese manufacturers don't want Euros. Hence we trade *currencies*. This makes a secondary market, for Euros and Yen. The foreign exchange is created because global trade requires it.

BRETTON WOODS CONFERENCE

The Bretton Woods conference, also known as the United Nations Monetary and Financial Conference, was a landmark international gathering held in July 1944 in Bretton Woods, USA. The conference was attended by 730 delegates from 44 representative countries. Countries wanted to establish multilateral economic cooperation to avoid the complications and painful situations faced during World War 2, the Great Depression and the trade wars that spread the depression globally.

> The seminal idea behind the Bretton Woods Conference was the notion of open markets. In his closing remarks at the conference, its president, U.S. Treasury Secretary Henry Morgenthau, stated that the establishment of the IMF and the IBRD marked the end of economic nationalism. This meant countries would maintain their national interest, but trade blocs and economic spheres of influence would no longer be their means. - Bretton Woods Conference - Wikipedia

Two notable results of this conference include the establishment of the **International Monetary Fund (IMF)** and the **International Bank for Reconstruction and Development (IBRD)** which was later renamed to something you might recognize today, the **World Bank**. The other important result, was the establishment of an adjust-ably pegged foreign exchange market rate system, where exchange rates were pegged to gold. Governments were only allowed to alter the rates by at most 10% without the involvement of the IMF and only to correct a "fundamental disequilibrium."

The system established a gold price of 35$ per ounce and participating currencies pegged their currency to the dollar. There was no "market" for currencies, just an somewhat adjustable fixed rate for currency conversion irrespective of supply and demand. This is simple, but completely disregards the fluctuating nature of supply and demand that economics tries to model & understand.

> For anybody that that knows anything about economics, you will know, that fighting the forced of supply and demand is like fighting the flow of water on a riverbank. Eventually, the continuous forces are going to win out. - Economics Explained - YouTube

THE END OF BRETTON WOODS, TODAY'S FOREX MARKET

> The first large crack in the system appeared in 1967, with a run on gold and an attack on the British Pound that lead to a 14.3% devaluation in the currency despite the efforts by the government to pull it back in line with

> it's predetermined level. Finally, president Nixon took the United States off the gold standard in 1971 (temporarily). And by late 1973, the system had collapsed and participating countries were allowed to float their currencies freely. This meant that currencies were traded on open markets just like shares or oil or beanie babies. The growth of global trade and the liberation of currencies to live their life at whatever value the market decided for them is why the market is so influential today - Economics Explained - YouTube

FOREIGN EXCHANGE PLAYERS

- **General public:** Makes up a very tiny percentage of market transactions. Primarily from holiday travel currency conversions and retail shopping on sites which do not support automatic currency conversions.
- **Institutional Investors:** Companies, Investment firms and Governments are big players in this market. Imagine company A is based in country a and wants to expand to country b, which uses b' currency. Company A now has to use its a' currency revenue from country a to buy up currency b' through the exchange market and then use it as investment in country b to expand there. However, remember that exchange rates are always fluctuating. Let's say company A makes 50% profit in country b, but b' has fallen in value harshly, completely negating the profit the business made in country b. This is a lot of risk that companies don't want to take. They would be willing to take risk in betting that their products and services would be a hit in country b, but they wouldn't want to deal with fluctuations in the exchange market which is outside their area of expertise. This is where other investment firms and speculative investors can help these businesses out by taking bets and helping the company by trading using DERIVATIVES - OPTIONS, which give peace of mind to the company and risk-reward potential for the speculative investors. Similarly governments can buy up chunks of foreign currency to influence the market, play politics, etc.