

## FOREX AND THE LIBERALIZED FINANCIAL MARKET

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*Lucrarea încearcă să prezinte înțelesul, metoda și mecanismul pieței Forex, precum și riscurile și oportunitățile participanților la acest fel de tranzacții. Autorii prezintă, pe scurt, rolul liberalizării continue a pieței financiare în contextul creșterii economice globale, precum și principalele caracteristici ale tranzacțiilor internaționale libere de capital.*

*The present paper is trying to introduce the meaning, method and mechanism of Forex market, as well as the participant's risks and opportunities in this sort of transactions. The authors also briefly present the role of the continuously liberalizing financial market into the environment of the global economic growth, as well as major concerns about the free capital international transactions.*

**Keywords:** exchange market, global finance, speculation

### 1. Introduction

The world nowadays, either we accept it or not, is open and interconnected. This concept of globalized world has brought with it an unprecedented economic development as well as uncertainty and crises.

One of the main concerns raised by the globalization and faced by a developing nation nowadays is whether or not to liberalize the capital account [1].

The economic history is full with examples of major financial and economic crises generated by speculations with capital and currency as the Mexico crisis in the 80's, European Monetary System's crisis in the 90's or the Asian crisis in 97'-98'.

The paper is describing a major market for currency speculations: the FOREX (Foreign Exchange). Its meaning, method and mechanisms, as well as the participant's risks and the opportunities in this sort of transactions are revealing a specific and little regulated competitive market. Is this ideal for the "market fundamentalism" (as George Soros very well emphasized [2]) to be extended beyond the currency transactions or to be regulated and imposed like other financial markets, in order to control the negative aspects of speculative monetary deals?

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## 2. What exactly the FOREX is?

In this paper the author's opinion represents an example of a free market. Given the size of this currency exchange market (30 times larger than the New York stock market transactional volume, or, in other words, the equivalent of more than 3 billion dollars a day), FOREX is the largest financial market in the world.

A transaction in this market means buying one currency and selling, at the same time, another one. The participants are represented, for about 95% of the transactions, by the small or the big speculators. They are only buying or selling currencies for generating profit from the difference between prices. The rest of the daily volume of transactions, for about 5%, is generated by the companies and the governments which buy or sell products and services abroad or which have to repatriate the profits made abroad and, in order to accomplish that action they have to exchange the foreign currency into the national currency.

“The majors” (the most transferred currencies, because they represent the best dealing opportunities for the speculators) represent 85% of the daily transactions. This offers a homogeneity character to FOREX market.

The transparency is given by the 24 hours day openness and the access to FOREX platforms which provides any type of market information that speculators require in order to take a decision. FOREX starts transaction in Sidney and moves around the globe, according to the opening financial days in every major city: Tokyo, London and New York. Investors are able to promptly respond to market changes. Unlike other financial markets, the investors are able to react to any currency exchange price fluctuations caused by economical, social and political events.

One of the main characteristics of FOREX is that it is considered an “Over the Counter” (OTC) market. This means that there are two counterparts who are dealing by phone or electronic networks.

But actually how does this market works?

The standard for all the transactions is the American dollar which is usually considered the “base” currency for the quotes [3]. For example, a quote of USD\JPY 110.01 means that one US dollar is equal to 110.01 Japanese YEN. The appreciation of the base currency unit, the dollar, is when the other currency quote goes up (down). The three exceptions to this rule are the British pound (GBP), the Australian dollar (AUD) and the Euro (EUR).

In these three currency pairs, where the US dollar is not the base rate, a raising quote means a weakening dollar. There are cases in which the US dollar is not involved: the cross currencies. For completing the explanation of the FX quotation we must say that the “bid” is the price at which the base currency can be sold and the “ask” is the price at which the base currency can be bought (at the same time selling the counter currency).

Base currency is the first currency of the currency pair. When the currency pair is represented as a ratio, like USD/CHF, or EUR/USD, the base currency is in the numerator. The price quote shows how much of the quote currency a unit of the base currency will buy. Quote currency is the second currency of the currency pair. When the pair is represented as a ratio, quote currency is in the denominator of the ratio. For example, in USD/CHF, CHF is the quote currency. The price quote shows how much of the quote currency a unit of the base currency will buy.

The main, and perhaps the most important feature that separates FOREX from other financial markets are the Leverage and the Margin. Leveraged trading or trading on the margin means that there is no requirement for putting up the full value of the position. In FOREX trading, the amount of leverage available could be up to 200 times the value of somebody's account.

Translated into risks and opportunities this implies not a lower but a limited risk to the value of the account (to the funds on the deposit). The higher than stock market's leverage offered by the FOREX market is due to the lower than active stock major currencies volatility. On a daily basis, the volatility of the majors is less than 1%, while an active stock can easily have a 5-10 % move in a single day. The main result is that leverage allows traders to increase their buying power and utilize less capital to trade. This increased leverage increases risk [4]. But the main benefit is that there is no interest paid for the leveraged amount. Stocks transactioning on the margin can prove costly, because the investor must pay an interest to the brokerage firm for the borrowed amount of money.

### **3. Instruments used on the FOREX market**

Like any other financial speculative market, FOREX uses a variety of instruments for forecasting price movements. In the following section of this paper the authors will briefly present the main instruments used by the actors of the FOREX market in order to forecast the evolution of the exchange rate.

Technical analysis is a method of forecasting price movements by looking at purely market generated data. The most commonly type of information analyzed by a technician is the price data from a particular market. The volume and the open interest trend in futures contracts is also an important feature in taking a decision.

The basic of FOREX technical analysis is the study of price charts before executing a trade. At their most basic level, these charts help traders determine the ideal entry and exit points for a trade. A few market conditions identified for the traders by charts are:

- Knowing if buying is made at a fair price (based on the price history of a particular market).
- Knowing if the selling is realized at a cyclical top or perhaps throwing the capital into a choppy, sideways market.

The hypotheses of the technical analysis are the following ones:

- All of the fundamentals are already represented in the price and in the way it fits into a pattern or a trend and in which way that pattern could be used to predict future prices because of that.
- The actual market fundamentals and various factors, such as the various opinions, hopes, fears and moods of the market participants need to be studied.
- The trend is cyclical and therefore markets move in fairly predictable or at least quantifiable patterns (signals). The purpose of the technical analysis is to uncover the signals of a current market by examining past market signals.
- Prices move in trends and can move up, down or sideways. Once a trend is established, it usually shall continue for some period of time.

This hypothesis does not guarantee that the best decision will be taken or the right one. The lesson for a market fundamentalist is represented by the fact that, if the FOREX market resembles too much to a competitive market, the long time profit should resemble as well with the competitive market's profit.

Given the market size and the amount of the transactions we conclude that there is still a strong incentive to enter this market. It looks like FOREX represents the standard for any free market follower.

But the question which is imposed here is if this "El-Dorado" is sustainable (and we extrapolate to all the almost deregulated financial markets) or shall it finally collapse under the global socio-economic or its own weight forces.

In an attempt to understand the implications of the liberalized financial markets (from which we studied the FOREX model as case study in the first part of this paper), to global socio-economic system into which all the nations (opened or not) are involved.

The present global system is supported by an ideology which derives from the perfect competition theory. The hypotheses of this model are that markets lead to equilibrium and that the balance position represents the maximum point of efficiency in resources allocation. Any restriction posed on the free competition is distancing from the maximum efficiency and so, all the barriers have to be over passed.

The authors consider that (given the fact that their personal background was, for a while, represented by a totalitarian socialist economic system and that the present was shaped by the transition to the market economy and is designed by the European integration) any exaggerated or "fundamentalist" economic opinion (other putted by George Soros), is wrong.

Taking into account just the financial aspect of the economy, the authors are briefly mentioning the positive and the negative effects of a free (deregulated) financial global market on the general scale.

At first, the global economic system has to be studied as a duality: the hyper developed center (the western economies) and the suburbs (the south). They are connected and continuously interacting. Any action propagates from the middle to the extremities of the system and backwards. There is a strong interdependence and an interaction between them. This explains the Asian crisis in 1997-1998 which was one of the most profound financial crises in economic history. The financial liberalized markets didn't act as expected. Instead of being a shock absorber, it acted as a destroyer for the fragile economies by creating a positive feedback and chain reaction.

Stating it otherwise, the problem is the instability of the international finances. We must split the direct and the portfolio long time investments from the short time investments operated by the banks and the others. The financial authorities are another part of the problem. Extremely important in our opinion are the speculators (part of the portfolio investments), as well as the institutional investors (pension funds) and performance investors (hedge funds), which use the leverage effect of the financial system in order to obtain a profit.

The instability derives from the "going on the same track" behavior of the market actors. In essence, following a price chart in order to take an investment decision is simple. But a simple shock might be able to inverse a growing trend and, as the Asian crisis revealed, a fragile economy with an open financial market could be devastated. Short time investors (speculators, hedge-funds, commercial banks) react promptly to small changes in stocks or currencies quotations (as following the FOREX market rules for an exemplification). As the result of this behavior was the January 97's Thai baht crisis. When Quantum Fund (Soros's investment trust fund [5]) triggered the market signals by selling Thailand's currencies, the national financial authorities didn't react promptly and adequately. The other investors followed the same pattern and so, the Thailand's financial collapse was catastrophic.

If we analyze the effects of the short time investments reverse in all of the Asia's economies we can't demonstrate a connection between the capital account openness degree and the amplitude of the negative effects on the economy. We cannot say with certitude if the openness of the incipient and fragile financial system of some of the Asian affected countries (which weren't able to promptly respond to the outgoing investment trend) were the problem or not.

In order to illustrate the statement that the issue is not the openness degree of the capital account, but rather the instability of the financial system, we present the following examples:

- Thailand had a superior openness degree of the capital account than Malaysia has and was much more de-capitalized.
- Though Hong-Kong has a mature financial system, it was more affected than the well-protected China was.
- South Korea was affected too, although it maintained a couple of the capital account restrictions.

The question is if the financial could be managed and how, giving the fact that IMF itself was a part of the Asian crisis issue. During the crisis, IMF focused on the structural problems prescribing the standard recipe: “growing interest rate and reducing government's spending in order to stabilize the currency price and restitute international investors trust”. This time however, the issue was that a private system generated this fact and structural adjustments only exacerbated the backward investment trends. IMF seemed to refuse to understand what the nature of the problem was and was consequently unable to deal with it. IMF became a part of the crisis itself and not the solution, because it didn't react sufficiently prompt and because it is impossible to deal with a liquidity problem and in the same time to convert the debt.

A mature and complex analysis of the Asian financial market situation could have been a part of the counteracting of the problem. Instead, IMF was catalyzing for the exit of finances.

#### 4. Conclusions

We conclude that:

- There is of little importance whether a capital account is more or less deregulated, because the financial crises derive from the participants' investment behavior and from the global finance management.
- There is a real need for international financial institutions in order to control adequately and to counteract the negative aspects of the global finance.

FOREX is just a part of the grand financial puzzle but exemplifies the short time investors' behavior.

#### R E F E R E N C E S

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