All About...

the Foreign Exchange Market in the United States

By Sam Y. Cross

Federal Reserve Bank of New York

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FOREWORD

Over the past forty years, the Federal Reserve Bank of New York has published monographs about the operation of the foreign exchange market in the United States. The first of these reports, *The New York Foreign Exchange Market*, by Alan Holmes, was published in 1959. The second, also entitled *The New York Foreign Exchange Market*, was written by Alan Holmes and Francis Schott and published in 1965. The third publication, *Foreign Exchange Markets in the United States*, was written by Roger Kubarych and published in 1978.

Each of these publications presents a lucid and informed picture of the foreign exchange market and how it operates, filled with rich insights and reflecting a profound understanding of the market and its complex mechanisms. Roger Kubarych's report, written twenty years ago, provided a valuable analysis of the foreign exchange market that is still read and widely appreciated by persons interested in gaining a deeper understanding of that market.

But the foreign exchange market is always changing, always adapting to a shifting world economy and financial environment. The metamorphosis of the 1980s and '90s in both finance and technology has changed the structure of the market and its operations in profound ways. It is useful to reexamine the foreign exchange market from today's perspective.

The focus of the present book is once again on the U.S. segment of the global foreign exchange market. Chapters 1-3 describe the structure of the market and how it has changed. Chapters 4-6 comment on the main participant groups and the instruments that are traded. Chapters 7-8 look at foreign exchange trading from a micro, rather than macro, point of view—how an individual bank or other dealing firm sees things. Chapters 9-11 comment on some of the broader issues facing the international monetary system and how governments, central banks, and market participants operate within that system. This is followed by an epilogue, emphasizing that there are many unanswered questions, and that we can expect many further changes in the period ahead, changes that we cannot now easily predict.

Markets go back a long time—in English law, the concept was recognized as early as the 11th century—and it is interesting to compare today's foreign exchange market with historical concepts. More than one hundred years ago, Alfred Marshall wrote that "a perfect market is a district, small or large, in which there are many buyers and many sellers, all so keenly on the alert and so well acquainted in one another's affairs that the price of a commodity is always practically the same for the whole of the district."

Today's over-the-counter global market in foreign exchange meets many of the standards that classical economists expected of a smoothly functioning and effective market. There are many buyers and many sellers. Entry by new participants is generally not too difficult. The over-the-counter market is certainly not confined to a single geographical area as the classical standards required. However, with the advance of technology, information is dispersed quickly and efficiently around the globe, with vast amounts of information on political and economic developments affecting exchange rates. As in commodity markets, identical products are being traded in financial centers all around the world. Essentially, the same marks, dollars, francs, and other currencies are being bought and sold, no matter where the purchase takes place. Traders in different centers are continuously in touch and buying and selling from each other. With trading centers open at the same time, there is no evidence of substantial price differences lasting more than momentarily.

Not all features of today's over-the-counter market fully conform to the classical ideals. There is not perfect "transparency," or full and immediate disclosure of all trading activity. Individual traders know about the orders and the flow of trading activity in their own firms, but that information may not be known to everyone else in the market. However, transparency has increased enormously in recent years. With the growth of electronic dealing systems and electronic brokering systems, the price discovery process has become less exclusive and pricing information more broadly disseminated—at least for certain foreign exchange products and currency pairs. Indeed, by most measures, the over-the-counter foreign exchange market is regarded by observers as not only extremely large and liquid, but also efficient and smoothly functioning.

Many persons, both within and outside the Federal Reserve, helped in the preparation of this book, through advice, criticism, and drafting. In the Federal Reserve, first and foremost, before his tragic death, Akbar Akhtar was a close collaborator on the project over an extended period, contributing to all aspects of the effort and helping to produce much of what is here. Dino Kos and his colleagues in the Markets Group were exceedingly helpful. Allan Malz contributed in many important ways. Robin Bensignor, John Kambhu, and Steven Malin also provided much valuable assistance, and Ed Steinberg's contribution as editor was invaluable. At the Federal Reserve Board, Ralph Smith offered very useful suggestions and comments.

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CHAPTERS

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