CLASS OF BUSINESS TRAINING

FOREX

Class Eight

NKWALI TRAINING CONSULTANTS (PTY) LTD

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INTRODUCTION

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INTRODUCTION TO FOREX CLASS OF BUSINESS TRAINING

The foreign exchange (forex) market is recognized as one of the largest and most liquid investment platforms within the ever-evolving financial landscape. This comprehensive forex training program is specifically designed to provide participants with the critical skills and knowledge required to successfully navigate the intricacies of forex trading.

Throughout this training, participants will receive an introduction to forex investments, gaining insights into the various market participants and the overall structure of the forex market. Additionally, there will be a focus on understanding currency as an asset class, which is essential for making informed investment decisions.

Participants will also explore the regulatory framework that governs forex trading, along with key concepts and instruments relevant to the market. The program will cover applicable fees, costs, and tax implications, ensuring that attendees are well-prepared to engage in forex trading with a solid foundation of knowledge.

CHAPTER 1: INTRODUCTION TO FOREX INVESTMENTS

Learning outcomes:

By the end of this chapter, participants will be able to:

1. Define forex investment and its relevance in the global financial market.

2. Identify and describe the different participants and role players in the forex market, including investors, brokers, banks, and regulators.

3. Understand the concept of currency as an asset class, including its characteristics and benefits.

4. Recognize the importance of forex investments in the global economy.

5. Describe common forex trading strategies, including their advantages and disadvantages.

6. Explain the importance of risk management in forex trading, including techniques for managing risk.

7. Understand the psychological and emotional factors that influence forex trading decisions, including strategies for maintaining emotional control.

1. DEFINING FOREX INVESTMENTS

Forex investment revolves around trading financial instruments in the foreign exchange market, capitalizing on fluctuations in currency prices. It excludes transactions regulated by Exchange Control laws conducted through bureaux de change. Successful forex investment necessitates a comprehensive understanding of the foreign exchange market and the factors influencing currency valuation.

2. THE MARKET DEFINED

The Foreign Exchange Market is a decentralized global financial platform facilitating the buying and selling of currencies worldwide. Major financial centers enable transactions between a diverse range of buyers and sellers, operating continuously, excluding weekends. With an estimated daily trading volume of $5.3 trillion, it is the largest financial market, responsible for determining the relative values of currencies. The foreign exchange market is paramount for international investment, trade, and financial transactions, allowing borrowers to obtain financing in their preferred currency and serving as an integral component of the global capital market.

3. HOW FOREX MARKETS ARE STRUCTURED

The foreign exchange market is highly interconnected worldwide, operating 24 hours a day across multiple time zones. The most prevalent method of currency trading occurs through bank deposits in major financial centers like London, New York, Tokyo, and Singapore, where most global banks are headquartered. When one major market closes, another opens, enabling continuous trading across different time zones.

There are three primary time zones in the forex market. The market commences at 1 a.m. Greenwich Mean Time (GMT) when Tokyo opens, with the Far Eastern time zone dominating until 9 a.m. GMT. At this point, trading in cities like London, Frankfurt, Paris, and Zurich begins in the European time zone. From 2 p.m. GMT, trading in New York initiates the American time zone, concluding at 10 p.m. GMT. On the West Coast, dealers in San Francisco and Los Angeles continue operations until Tokyo reopens the following day.

The foreign exchange markets encompass both spot markets and contract markets. A spot trade involves an immediate transaction with payment due on a predetermined settlement date, typically T+2 (two business days after the trade date), as per international convention. Additionally, a substantial derivatives market operates in conjunction with the forex market, primarily dealing in forward exchange contracts, currency swaps, futures, and options.

Foreign exchange can only be bought and sold on the primary wholesale market, where accounts are exchanged. There is no secondary market, as transactions offset the initial exchange. The spot foreign exchange market operates as an over-the-counter market, while the forex derivative market functions as both an over the counter and an exchange-traded market.

Major banks act as "market makers" in the forex market, simultaneously providing clients with both buying (bid) and selling (offer) prices. By market convention, clients specify the transaction value but not whether they are buying or selling. The prices offered by Bureaux de Change align with those set in the quote-driven over-the-counter market.

Order trading in the forex market occurs exclusively in the wholesale sector, where forex brokers operate, trading with other market makers. Banks place orders with dealers, who then disseminate the orders to other market makers. The forex market operates through a telephone-screen trading system, where prices are shared via phone services like Reuters, but these are indicative rates only. Transactions are executed by calling banks and obtaining firm quotes for buying or selling.

In the telephone-screen trading system, banks provide quotes to their customers, while in the automatic trading system (ATS), banks trade with each other globally. The "telephone-screen trading system" refers to the practice of banks displaying exchange rates on computer screens accessible worldwide (Reuters, Bloomberg). However, these are not fixed rates, and banks will not transact at these rates. They are advertising rates, prompting customers to call banks and request quotes after specifying their desired transaction amount. The rates provided are then firm prices.

As mentioned earlier, forex dealers only take orders, while banks trade in the market and set prices. However, banks occasionally accept specific orders, typically from smaller clients, acting in dual roles.

Most transactions occur between banks, with hundreds of banks trading forex (acting as principals) in both the spot and forward markets, making the forex market primarily an interbank market. Banks quote rates for their home currency against the US dollar and other currencies. Additionally, some banks in certain regions and countries also quote third currencies against the USD.

Before trading with each other, banks formalize their relationship by signing the International Foreign Exchange Master Agreement, which outlines details such as transaction size, delivery, netting, and credit limits.

4. TRADING MECHANISMS AND PLATFORMS IN THE FOREX MARKET

The forex market operates through an over the counter (OTC) structure, facilitated by a global network of banks, financial institutions, and electronic trading platforms. Unlike traditional stock exchanges, there is no centralized physical location for forex trading. Instead, transactions are

conducted electronically, 24 hours a day, five days a week, across major financial centers worldwide.

Forex trading platforms play a crucial role in facilitating the execution of trades and providing market participants with access to real-time quotes, charting tools, and analytical resources. These platforms can be broadly categorized into two main types:

1. **Dealing Desk Platforms**: In this model, the forex broker acts as a market maker, taking the opposite side of a client's trade. The broker sets the bid and ask prices, and profits from the spread (the difference between the bid and ask prices).

2. **Non-Dealing Desk Platforms (ECN/STP):** These platforms connect traders directly to liquidity providers, such as banks and other market makers, without the broker acting as a counterparty. Trades are executed at the best available prices in the interbank market, and the broker earns a commission or markup on the spread.

Popular forex trading platforms used by retail traders include MetaTrader 4 (MT4), MetaTrader 5 (MT5), and proprietary platforms offered by various brokers. These platforms offer a range of features, including real-time quotes, charting tools, technical indicators, automated trading strategies (Expert Advisors), and mobile trading capabilities.

Regardless of the platform used, forex trading involves the simultaneous buying of one currency and selling of another, with the goal of profiting from fluctuations in exchange rates. Traders can speculate on currency pairs, such as EUR/USD (Euro/US Dollar) or GBP/JPY (British Pound/Japanese Yen), based on their analysis of economic fundamentals, technical indicators, and market sentiment.

5. MAJOR CURRENCY PAIRS AND TRADING HOURS

The forex market revolves around the world's most actively traded currencies, which are typically divided into major, minor, and exotic currency pairs. The major currency pairs, which account for a substantial portion of overall forex trading volume, include:

- EUR/USD (Euro/U.S. Dollar)
- USD/JPY (U.S. Dollar/Japanese Yen)

- GBP/USD (British Pound/U.S. Dollar)
- AUD/USD (Australian Dollar/U.S. Dollar)
- USD/CAD (U.S. Dollar/Canadian Dollar)
- USD/CHF (U.S. Dollar/Swiss Franc)
- NZD/USD (New Zealand Dollar/U.S. Dollar)

The forex market operates 24 hours a day, five days a week, with trading sessions overlapping across major financial centers around the world. The four major forex trading sessions are:

- Sydney Session (2:00 AM - 10:00 AM ET)
- Tokyo Session (7:00 PM - 4:00 AM ET)
- London Session (3:00 AM - 12:00 PM ET)
- New York Session (8:00 AM - 5:00 PM ET)

The highest trading volume and liquidity typically occur during the overlap of the London and New York sessions, when both European and North American markets are actively trading

6. CURRENCY AS AN ASSET CLASS

Foreign exchange has traditionally been viewed by institutional investors as a byproduct of global asset allocation choices. However, over time, investment banks and other organizations have developed currency overlap products to help such investors actively manage foreign exchange risk, allowing them to potentially achieve higher overall returns on their investments. More recently, a growing number of investors have become interested in currencies as an asset class in their own right, frequently without making a decision to buy foreign equities.

Several factors, in addition to the expanded availability of technical platforms, contribute to this trend:

- Currency values exhibit a low correlation with other asset classes like stocks and bonds, making them an ideal option for portfolio diversification.
- Some commentators believe that currency markets have exploitable inefficiencies due to the presence of commercial hedgers and governments who do not primarily pursue profit maximization.
- Currency prices are relative, making it difficult for all currencies to fall at the same time, unlike other asset classes like stocks which can experience broad market declines.
- Insider trading is nearly impossible in foreign currency markets due to their sheer scale and vast number of participants, especially for major currencies. In recent years, a variety of investment products have been developed to allow institutional investors to profit directly from exchange rate fluctuations. Foreign currency transactions by non-bank financial organizations, such as collective investment schemes, pension funds, and insurance firms, have expanded dramatically. A significant portion of this trade has been driven by rising interest in currencies as an asset class in and of themselves, rather than merely as a byproduct of other investment decisions.

7. ROLE PLAYERS IN THE FOREIGN EXCHANGE MARKET

The foreign exchange market is a vast and intricate ecosystem, with numerous participants engaging in various capacities. This diverse array of players contributes to the market's liquidity, efficiency, and global reach.

7.1 Commercial Banks. Commercial banks play a pivotal role in the foreign exchange market, engaging in multiple ways:

- Retail and Wholesale Foreign Exchange Services: As part of their core financial services, commercial banks facilitate the buying and selling of foreign currencies on behalf of their clients, catering to both individual and institutional customers.
- Market Making and Intermediation: Acting as market makers and intermediaries, commercial banks actively engage in foreign exchange trading, providing liquidity and facilitating transactions.

- Proprietary Trading and Risk Management: Commercial banks leverage the interbank foreign exchange market to manage their own foreign currency positions. This interbank market has evolved into an interdealer marketplace, where commercial banks compete directly with investment banks and other financial institutions as dealers.

7.2 Non-Banking Institutions In pursuit of global portfolio diversification and risk management, institutional investors such as mutual funds, insurance companies, hedge funds, and pension funds actively participate in the foreign exchange market. These entities leverage foreign currency transactions to optimize their investment strategies and mitigate currency-related risks.

7.3 Businesses and Corporations: Global trade necessitates the involvement of businesses and corporations in the foreign exchange market. Importers require foreign currencies to pay their suppliers, while exporters must convert their foreign earnings into local currency. Both importers and exporters may seek to hedge against currency exposures arising from their international trade activities. Increasingly, large multinational corporations are bypassing intermediaries like banks and engaging directly in the foreign exchange market. This direct participation is particularly prevalent among companies that own overseas factories, facilities, or frequently source components from abroad.

7.4 Central Banks: Central banks play a crucial role in the foreign exchange market, intervening when necessary to influence exchange rates or adjust the supply of their respective currencies. Additionally, central banks facilitate foreign exchange transactions for their governments and public sector entities, such as postal services, railways, and airlines, acting as the country's foreign banker.

7.5 Foreign Exchange Dealers: The majority of foreign currency dealers and traders are employed by banks authorized to deal in foreign currencies. These dealers act as market makers, quoting both buying and selling prices for currencies, assuming principal risk, and enabling prompt order execution by taking the opposite side of transactions. Unlike commission-based models, foreign exchange dealers generate profits from the spread between the prices they quote to clients and to other dealers. In addition to providing

quotes for client foreign exchange requirements, dealers often take speculative long or short currency positions, aiming to profit from anticipated exchange rate movements.

7.6 Foreign Exchange Brokers : Foreign exchange brokers serve as intermediaries between banks seeking to buy and sell specific currencies, rather than acting as principals in the transactions themselves. These brokers facilitate the matching of orders by providing currency buying and selling quotes to dealers on behalf of other foreign exchange dealers. For instance, if a bank wishes to purchase South African rand and sell US dollars at a specific price, it will provide this order to a broker, who will then disseminate the order anonymously to other banks in the market. Once a matching order is found, the transaction is executed, with the brokers earning commissions or brokerage fees for facilitating the trade. Brokers do not assume the risk of open-currency positions; instead, they profit from the commissions charged on the transactions they facilitate. Many banks leverage computerized broking services to streamline their foreign exchange trading operations.

7.7 Non-Bank Foreign Exchange Companies: In addition to banks and brokers, non-bank foreign exchange companies offer currency exchange and international payments services to individuals and businesses. These companies, also known as foreign exchange brokers or retail forex brokers, act as market makers and facilitate the buying and selling of foreign currencies at quoted prices. Unlike banks, which deal primarily with larger institutional clients, non-bank forex companies cater to a wider range of customers, including individual traders, small businesses, and corporations. They provide trading platforms and educational resources to help clients navigate the foreign exchange market and execute trades. Non-bank forex companies generate revenue through the bid-ask spread on currency pairs, as well as by charging commissions or fees on transactions. They may also offer additional services such as currency risk management solutions, international money transfers, and foreign exchange advisory services.

7.8 Foreign Exchange Trading Platforms: The foreign exchange market operates through an electronic network of banks, brokers, and trading platforms. These platforms facilitate the buying and selling of currencies by providing real-time quotes, order execution, and trading tools.

Major banks and institutional investors typically use proprietary trading platforms or electronic communication networks (ECNs) to access the interbank market and execute large-volume transactions. These platforms offer advanced trading features, sophisticated order types, and direct access to liquidity providers.

Retail traders and individual investors often use online trading platforms provided by forex brokers or banks. These platforms offer user-friendly interfaces, charting tools, technical analysis indicators, and access to educational resources. Many also provide mobile apps, allowing traders to monitor and execute trades on-the-go.

Regardless of the platform, foreign exchange trading involves the simultaneous buying and selling of currency pairs, with the aim of profiting from fluctuations in exchange rates. Traders can take long or short positions, leveraging their capital to amplify potential gains or losses.

8 FOREX TRADING STRATEGIES

Successful forex trading requires a well-defined strategy and effective risk management techniques. Some common trading strategies include:

- **Fundamental Analysis:** Evaluating economic, political, and social factors that influence currency values.
- **Technical Analysis:** Identifying patterns and trends in price movements to forecast future price behavior.
- **Carry Trade:** Borrowing a low-interest currency to invest in a higher-yielding currency, profiting from the interest rate differential.
- **Scalping**: Taking advantage of small, frequent price movements by opening and closing positions quickly.

9 RISK MANAGEMENT IN FOREX TRADING

While the foreign exchange market offers numerous opportunities for profit, it also carries significant risks. Successful forex trading requires a comprehensive risk management strategy to protect against potential losses.

Some key risk management practices include:

- **Proper Capitalization**: Traders should ensure they have sufficient capital to withstand potential drawdowns and avoid over-leveraging their positions.
- **Stop-Loss Orders**: Setting predetermined stop-loss levels can help limit losses if the market moves against a trader's position.
- **Position Sizing**: Determining appropriate position sizes based on account size and risk tolerance can help manage risk exposure.
- **Diversification**: Spreading investments across different currency pairs, time frames, and trading strategies can help mitigate overall portfolio risk.
- **Continuous Education**: Staying up to date with market trends, economic indicators, and trading techniques can help traders make informed decisions and adapt to changing market conditions.

Effective risk management is crucial in the highly volatile and leveraged foreign exchange market. By implementing sound risk management practices, traders can increase their chances of long-term success and protect their capital from substantial losses.

10 PSYCHOLOGY AND EMOTIONAL CONTROL

Forex trading is not just about mastering technical skills and strategies; it also requires a solid grasp of psychology and emotional control. The foreign exchange market can be highly volatile, and traders often face intense emotional pressures, such as fear, greed, and overconfidence.

Successful traders understand the importance of managing their emotions and maintaining a disciplined approach. They strive to make objective decisions based on their trading plan and risk management strategies, rather than being swayed by impulsive emotions or market noise.

Some key psychological factors that traders should address include:

- **Developing a Mindset for Success:** Cultivating a positive and resilient mindset can help traders navigate the inevitable ups and downs of trading. This involves maintaining a growth mindset, learning from mistakes, and focusing on continuous improvement.
- **Overcoming Fear and Greed**: Fear can lead to hesitation and missed opportunities, while greed can result in excessive risk-taking and poor decision-making. Recognizing and managing these emotions is crucial for consistent performance.
- **Maintaining Discipline:** Adhering to a well-defined trading plan and risk management strategies can help traders avoid impulsive decisions and stay on track toward their goals.
- **Managing Stress and Emotions**: Implementing stress management techniques, such as meditation, exercise, or seeking professional support, can help traders maintain emotional balance and clarity during challenging market conditions.

By developing a strong psychological foundation and cultivating emotional intelligence, forex traders can enhance their decision-making abilities, increase their resilience, and ultimately improve their chances of long-term success in the dynamic and challenging foreign exchange market.

CHAPTER 2 : THE REGULATORY FRAMEWORK

Learning outcomes:

By the end of this chapter, participants will be able to:

1. Explain the exchange control regulations applicable to forex investments in South Africa.

2. Describe the Code of Conduct for authorized financial services providers conducting forex investments.

3. Outline the general responsibilities of Financial Services Providers (FSPs) conducting forex businesses.

4. Identify the disclosure requirements for FSPs conducting forex businesses.

5. List the prohibitions on FSPs conducting forex businesses.

6. Explain the importance of maintaining a Record of Advice for forex investment transactions.

7. Describe the purpose and content of a mandate for forex investment transactions.

8. Understand the insurance and guarantee requirements for FSPs conducting forex businesses.

9. Outline the special provisions applicable to forex financial advisors.

10. Explain the principles and objectives of the Forex Global Code of Conduct.

1. EXCHANGE CONTROL REGULATIONS

South African residents have been subject to exchange controls since the early 1930s, which were implemented by the apartheid regime in an effort to stem the outflow of capital during periods of political unrest. These controls have been periodically tightened and relaxed over the years. In recent years, South African authorities have adopted a strategy of low intervention in the currency market and gradual easing of exchange controls. This approach has facilitated increased foreign investment by South African individuals, investment institutions, and corporations. All parties involved in the foreign exchange market in South Africa should carefully examine the laws and regulations governing the control of foreign exchange. The relevant statutes are Section 9 of Act No. 9 of 1933 (Currency and Exchanges Act) and the Exchange Control Regulations of 1961.

Local exchange control regulations typically have the following features:

- Foreign exchange market transactions by non-authorized dealers must be accompanied by documentation demonstrating what the South African Reserve Bank (SARB) terms as a clear and ascertained foreign exchange commitment; speculation is thus prohibited.
- The exchange control regulations, enforced by the SARB, mandate the conversion of foreign currency proceeds from exporting goods into rand within a specific time frame.
- Only authorized dealers are permitted to trade in foreign exchange instruments and physical gold.

Individuals and Investments

An individual taxpayer is allowed to invest a maximum of R10 million per calendar year outside of the Common Monetary Area (comprising Lesotho, Swaziland, and Namibia). To invest abroad, one needs to obtain a tax clearance certificate. Furthermore, a tax clearance certificate is not necessary for international transfers up to R1 million made using the single discretionary allowance program.

2. CODE OF CONDUCT FOR FINANCIAL SERVICES PROVIDERS CONDUCTING FOREX INVESTMENT BUSINESS

Financial services providers authorized to offer foreign investment services must adhere to the Code of Conduct for Financial Services Providers conducting Forex Investment Business. This code serves as an additional layer of regulation, complementing the General Code of Conduct for authorized financial services providers and representatives, as well as any other applicable specific codes.

The code further defines foreign currency denominated investments, excluding foreign currency investments, as forex trading based on price fluctuations in the forex market, but excluding forex transactions conducted by authorized dealers and their agents. A notable addition to the regulations is the requirement for Forex Financial Services Providers (FFSPs) to undergo an application process to obtain approval from a clearing company or a foreign FFSP. This measure aims to enhance oversight and accountability within the industry. Moreover, the regulatory status of the foreign FFSP must be disclosed, and the regulatory regime under which it operates must meet the satisfaction of the commissioner of the Financial Sector Conduct Authority (FSCA).

The commissioner reserves the right to decline an application for approval of a clearing firm or foreign FFSP if the regulatory regime in the country of origin is deemed unsatisfactory. These measures underscore the regulatory authorities' commitment to maintaining high standards of conduct, transparency, and consumer protection within the forex investment sector. By implementing robust oversight mechanisms and stringent approval processes, the industry aims to foster a fair and ethical operating environment for all market participants.

3. GENERAL RESPONSIBILITIES OF A FOREX FINANCIAL SERVICES PROVIDER

As a Forex Financial Services Provider (FFSP), there are several critical responsibilities that must be upheld to ensure the proper handling of client investments and adherence to industry regulations. These responsibilities encompass a range of duties, from safeguarding client funds and acting in their best interests to maintaining transparency and avoiding conflicts of interest.

3.1 Guarantee that the investment funds are promptly transferred to the designated final destination as specified in the mandate. FFSPs are obligated to ensure that client funds are swiftly and accurately transferred to the intended investment vehicles, as outlined in the

client's investment mandate. This process must be executed with utmost care and diligence to prevent any delays or mishandling of funds.

3.2 Act in the best interests of the client. FFSPs have a fiduciary duty to prioritize the client's interests above all else. They must make investment decisions and provide advice that aligns with the client's financial goals, risk tolerance, and overall well-being.

3.3 Act in good faith and with due skill, care, and diligence. FFSPs are expected to conduct their operations with integrity, exercising the appropriate level of skill, care, and diligence required in the financial services industry. This includes staying up to date with market trends, regulations, and best practices to ensure the highest quality of service.

3.4 Adhere to market conduct standards. FFSPs must comply with the established market conduct standards and regulations governing the forex industry. These standards are designed to promote fair and ethical practices, protect investors, and maintain the integrity of the financial markets.

3.5 Provide clients with information about the client's investment, market practices and risks inherent in the different products. Transparency is key in the financial services industry. FFSPs are obligated to provide clients with comprehensive information about their investments, market practices, and the inherent risks associated with different financial products. This empowers clients to make informed decisions and understand the potential implications of their investments.

3.6 Obtain from client's information about the client's financial situation, investment experience and investment objectives. To provide tailored advice and recommendations, FFSPs must gather relevant information about the client's financial situation, investment experience, and investment objectives. This information is crucial in determining the appropriate investment strategies and products that align with the client's unique circumstances and goals.

3.7 Avoid conflicts of interest but if they arise, disclose them to the client or decline to act for the client. FFSPs must prioritize the client's interests and avoid situations where their own interests may conflict with those of their clients. In the event that a conflict of interest

arises, they are required to disclose it to the client transparently or, if necessary, decline to act on behalf of the client to maintain impartiality.

3.8 Explain to a client how fees and other charges are calculated in sufficient detail to enable the client to understand the method of calculation. Clients have the right to understand the fees and charges associated with the services provided by FFSPs. FFSPs must provide detailed explanations of how these fees and charges are calculated, ensuring that clients can comprehend the methodology and make informed decisions.

3.9 Ensure that its staff and representatives are trained as required by the Financial Advisory and Intermediary Services Act 37 of 2002 (FAIS Act). FFSPs are responsible for ensuring that their staff and representatives receive proper training and meet the qualifications outlined in the Financial Advisory and Intermediary Services Act 37 of 2002 (FAIS Act). This ensures that clients receive professional and competent service from knowledgeable individuals.

3.10 Apply for approval to the commissioner prior to appointing a clearing firm or foreign FFSP in terms of the Regulations. Before engaging with a clearing firm or foreign FFSP, FFSPs must obtain approval from the relevant commissioner, as stipulated by the applicable regulations. This process helps maintain oversight and ensures compliance with industry standards. By fulfilling these general responsibilities, FFSPs can uphold their professional obligations, maintain the trust of their clients, and contribute to the overall integrity and stability of the financial markets.

4. DISCLOSURE REQUIREMENTS FOR FOREX FINANCIAL SERVICES PROVIDERS

Forex financial services providers (FFSPs) are required to disclose certain information to their clients to ensure transparency and protect the interests of investors. The following details must be provided:

4.1 If a foreign FFSP is involved, the extent of its powers over clients' funds must be disclosed, along with assurances that client funds are kept separately and segregated.

4.2 All fees and charges, whether direct or indirect, must be disclosed to clients in a clear and transparent manner.

4.3 Any non-cash incentives or indirect consideration payable to the FFSP by another financial services provider, product supplier, or other party must be disclosed.

4.4 The name, address, and regulatory details of any foreign FFSP or clearing firm involved, including whether they are registered with the relevant foreign regulator, must be provided.

4.5 Information on whether the foreign FFSP or clearing firm has insurance coverage against fraud, dishonesty, and negligence, and the extent of such coverage, must be disclosed.

5. PROHIBITIONS ON FOREX FINANCIAL SERVICES PROVIDERS

To protect the interests of clients and maintain ethical practices, FFSPs are prohibited from engaging in certain activities, either directly or indirectly:

5.1 Inducing a client to enter into a mandate or any other agreement relating to forex investments through misleading statements, promises, forecasts, or any other deceptive actions.

5.2 Selling or providing a third party with a client's personal details without the client's prior written consent.

5.3 Charging a client termination fees, except for accrued fees for services rendered before the termination of the agreement.

5.4 Receiving, intermediating, or dealing with funds that have not been cleared under applicable exchange control laws.

5.5 Advising a client to deal in a self-directed forex account (where the client has discretionary dealing power) or, in the case of a managed account, dealing on behalf of a client where the minimum leverage applied regularly exceeds industry norms.

5.6 Churning the client's account (excessive trading to maximize commissions or revenue for the FFSP).

5.7 Quoting hypothetical investment returns or real investment returns for a period shorter than 12 months when promoting or advertising forex investments.

5.8 Stating or implying in the promotion or advertising of forex investments that past investment returns will be repeated.

6. DISCLOSURE REQUIREMENTS FOR FOREX FINANCIAL SERVICES PROVIDERS

To maintain transparency and protect the interests of clients, FFSPs must disclose certain information to clients in a clear and concise manner:

6.1 The risks associated with forex investments, including the potential for significant losses due to the leveraged nature of the market.

6.2 The fees and charges applicable to the client's account, including commissions, spreads, overnight financing charges, and any other relevant costs.

6.3 The FFSP's policy on the treatment of client funds, including whether client funds are segregated from the FFSP's operational funds and the measures in place to safeguard client funds.

6.4 The FFSP's order execution policy, including information on how orders are executed, the factors that influence execution, and the potential for slippage or requotes.

6.5 The FFSP's conflict of interest policy, detailing how potential conflicts of interest are identified and managed.

6.6 The FFSP's complaints handling procedure, including the contact details of the relevant regulatory authority for filing complaints.

7 RECORD KEEPING REQUIREMENTS

FFSPs must maintain accurate and up-to-date records to ensure compliance with regulatory requirements and facilitate the resolution of disputes or complaints. The following records must be kept for a minimum period of five years:

7.1 Client agreements, account opening documents, and risk disclosure statements signed by clients.

7.2 Records of all transactions executed on behalf of clients, including trade confirmations, account statements, and other relevant documentation.

7.3 Records of all communication with clients, including emails, chat transcripts, and telephone recordings.

7.4 Records of all marketing and promotional materials used by the FFSP.

7.5 Records of all complaints received from clients and the actions taken to resolve them.

7.6 Records of all training and competency assessments conducted for the FFSP's employees and representatives.

8 MANDATE

Forex financial services providers (FFSPs) must obtain a signed or electronic mandate that outlines the arrangements between the client and the FFSP before rendering intermediary services. This applies whether the client opens a self-directed or managed account. Electronic mandates must follow procedures ensuring personal identification and information security.

The mandate must include provisions for:

8.1 Whether the investment is self-directed or managed.

8.2 The investment objectives.

8.3 For managed investments: investment/jurisdiction restrictions (regulatory environment, specific currency pairs), limitations on maximum drawdown, leverage, margin requirements, and margin call rules.

8.4 A statement of risks inherent to forex investments (currency, event, operational, leverage).

8.5 Whose name the forex investments will be made under (client, omnibus account holder controlled by foreign FFSP, or omnibus account holder controlled directly/indirectly by the FFSP).

8.6 Bank details of the FFSP and foreign FFSP or clearing firm.

8.7 How, and at what intervals, cash accruals received by the FFSP on the client's behalf must be paid over.

8.8 Restrictions on withdrawals of principal amounts or profits, if applicable.

8.9 How, and at what intervals, the FFSP's remuneration will be calculated. This cannot be at the discretion of any person.

8.10 Whether the FFSP receives commission, incentives, fee reductions or rebates from a foreign FFSP or other institution for placing funds with it.

8.11 A statement that a transaction report from the foreign FFSP acting as clearing member must be made available to the client within 24 hours of the FFSP/foreign FFSP receiving it.

8.12 Provisions allowing either party to terminate the mandate with up to 60 days' written notice.

8.13 Details of insurance covering losses due to fraud, dishonesty, and negligence. Prior to entering any mandate, the FFSP must obtain approval for a specimen mandate. When drafting an actual mandate, no substantial amendments may be made to the approved specimen without the commissioner's approval. Upon mandate termination, all cash, financial products and documents of title must be returned to the client with a detailed statement of account

9 REPORTING TO CLIENTS BT FOREX INVESTMENT INTERMEDIARIES

Written or electronic client reports detailing investment performance up to the last day of the previous calendar month must be furnished on request or, for managed accounts, monthly.

The report must enable the client to prepare financial statements, determine the investment's market value changes, and view charges levied over the period.

Upon request, an FFSP must also supply:

9.1 The forex investment's original and current market values.

9.2 Currency pairs purchased and sold during the period.

9.3 Cash receipts and payments during the period.

9.4 Profits and losses realized during the period.

9.5 The leverage employed during the reporting period.

10 INSURANCE AND SUITABLE GUARANTEES

FFSPs must maintain guarantees or professional indemnity/fidelity insurance as determined by the commissioner. If an FFSP does not hold client investments in custody, it must ensure the foreign FFSP or clearing firm holding such deposits maintains the required insurance cover.

11 SPECIAL PROVISIONS FOR FOREX INVESTMENT ADVISORS (FIA)

Forex Investment Advisors (FIAs) bear a significant responsibility in ensuring the integrity and legality of their client referrals. Prior to directing a client to a forex intermediary, an FIA must diligently verify whether the intermediary holds the necessary authorizations. Should the intermediary lack proper authorization, the FIA is prohibited from making any referrals to that intermediary.

When establishing a business relationship with a client, the FIA must initiate the process with a comprehensive written or electronic application form. This document serves to formally record the arrangement between the parties involved, including pertinent details about the intermediary. The FIA must ensure that the application form includes the following critical disclosures:

11.1 Specify whether the FIA collaborates with one or multiple intermediaries.

11.2 Clarify whether the client will engage with the intermediary directly or through the FIA.

11.3 Indicate whether the advisory services pertain to a managed account or a self-directed account.

11.4 Provide the contact details for the FIA, the intermediary, and the client.

11.5 Confirm that the intermediary is an authorized Financial Services Provider (FSP), including their license number.

11.6 Detail whether investments in managed forex accounts will be executed in the client's name at the foreign FSP acting as a clearing firm or under an omnibus account holder's name, which is under the direct or indirect control of the FSP.

11.7 Include information regarding applicable exchange control measures affecting the forex investment.

11.8 State the amount and terms of the investment.

11.9 Disclose the total fees and benefits to be received by both the FIA and the intermediary, whether these are deducted from the investment or provided in other forms. This should encompass initial fees, ongoing costs, and any additional benefits, whether in cash or kind.

The FIA is obliged to seek approval for the application form from the commissioner. Any substantial modifications to the specimen application form are prohibited without prior approval from the commissioner.

Additionally, the FIA must formalize a written agreement with each forex intermediary, which delineates the arrangements in place. This agreement should encompass provisions for client reporting by the intermediary and stipulate termination rights, which should not exceed a notice period of 60 days.

12 RECORD OF ADVICE

In alignment with best practices, the FIA must meticulously maintain a record of the advice provided to the client, which should encapsulate the following elements:

12.1 A concise summary of the information and materials upon which the advice was predicated.

12.2 A detailed account of the financial products that were considered.

12.3 A thorough description of the specific forex investment recommended, along with a rationale as to why this investment aligns with the client's identified needs and objectives.

12.4 Each client's investment must be documented individually, and the FIA is responsible for providing the client with a copy of this record of advice.

13 FOREX GLOBAL CODE OF CONDUCT

The Forex Global Code represents a comprehensive framework of principles designed to promote good practices within the foreign exchange market. Established through a collaborative effort among market participants and central banks from 16 jurisdictions globally, the Code seeks to provide a unified set of guidelines aimed at enhancing the integrity and operational efficiency of the wholesale foreign exchange market.

The overarching goal of the Global Code is to foster a market that is robust, fair, liquid, open, and suitably transparent. Such a market should enable effective and confident transactions among a diverse range of participants at competitive prices, reflective of accessible market information. This should occur in a manner consistent with recognized standards of behavior and supported by resilient infrastructure.

It is important to note that the Global Code does not impose legal or regulatory obligations upon market participants, nor does it serve as a substitute for existing regulations. Instead, it is intended to complement local laws, rules, and regulations by establishing the best global practices and processes.

For further details, the complete Global Code is accessible online at the following link: [FX Global Code](https://www.globalfxc.org/docs/fx_global.pdf).

By understanding and adhering to the relevant regulatory frameworks, forex market participants can operate within the bounds of the law, mitigate risks, and contribute to a fair and transparent trading environment.

CHAPTER 3: FOREX CONCEPTS

Learning outcomes:

By the end of this chapter, participants will be able to:

1. Define the monetary unit and its relevance in forex transactions.
2. Explain foreign exchange rates and how they are determined.
3. Describe different exchange rate regimes, including fixed, floating, and managed float.
4. Identify and explain the use of ISO codes and SWIFT in forex transactions.
5. Calculate percentage in point (pip) values and understand their significance in forex trading.
6. Distinguish between direct and indirect quotations and provide examples of each.
7. Explain inverse and reciprocal quotations and how they are used in forex transactions.
8. Understand the concepts of bids and offers and how they relate to forex trading.
9. Convert amounts between base and variable currencies using exchange rates.
10. Calculate the bid-offer spread and understand its impact on forex transactions.
11. Explain cross rates and how they are used in forex transactions.
12. Define and explain appreciation and depreciation in foreign exchange rates.

In the realm of foreign exchange, understanding the dynamics of currency fluctuations is crucial for both individual investors and large corporations. Exchange rates are influenced by a myriad of factors, including economic indicators, geopolitical events, and market sentiment. For instance, a country's interest rates can significantly impact its currency value; higher interest rates typically attract foreign capital, leading to an appreciation of the currency. Additionally, political stability

and economic performance play vital roles in determining investor confidence, which in turn affects currency demand. As such, staying informed about these variables is essential for making informed trading decisions in the forex market.

1. FOREX FUNDAMENTALS

1.1 The monetary unit

The monetary unit serves as a fundamental element in the foreign exchange market, as it represents the standard measure of value for transactions within a country. Each nation’s currency is not only a reflection of its economic health but also a tool for international trade, influencing how goods and services are priced globally. For example, fluctuations in the monetary unit can affect export competitiveness; a stronger currency may make a country's exports more expensive for foreign buyers, potentially reducing demand. Conversely, a weaker currency can boost exports by making them more affordable on the international market. Understanding these dynamics is essential for traders and investors who seek to capitalize on currency movements and their implications for global commerce.

Currency exchanges are an inevitable part of international trade and investment, which involves nearly every country in the globe. The notes and coins of a country are its legal tender, and any investment denominated in that unit of money is known as a bank deposit in the foreign exchange market. These two components make up a country's currency.

When talking about money, "foreign currency" is shorthand for the currencies of other countries, as opposed to the currency of one's own country.

1.2 Foreign Currency Exchanges

Securities and deposits denominated in a currency other than the country's official currency are known as foreign exchange.

Understanding the mechanics of currency pairs is essential for traders involved in foreign exchange transactions. Each currency pair reflects the relative value of one currency against another, and fluctuations in these values can be influenced by various factors such as economic data releases, interest rate changes, and geopolitical events.

For example, if the economic outlook for the base currency improves, it may strengthen against the quoted currency, leading to potential profits for traders who have positioned themselves accordingly. Traders often use technical analysis to identify patterns and trends in currency movements, which can further enhance their trading strategies and decision-making processes in the forex market.

In this context, a currency pair serves as the unit of measurement for quoting foreign exchange rates.

In the analysis of currency exchange rates, consider the example of an exchange rate of 18.0257 USD/ZAR. In this notation, the currency on the left side of the slash is referred to as the base currency, which in this case is the US dollar (USD). The currency on the right side, known as the quoted or variable currency, is the South African Rand (ZAR). This rate indicates that one US dollar is equivalent to 18.0257 South African Rand, reflecting the value of the base currency in terms of the quoted currency.

You can use these conversion rates to determine the cost or profit of buying or selling the base currency.

Exchange rates can be categorized into two main types: fixed and floating. A fixed exchange rate is one that is pegged to another major currency, providing stability and predictability for international trade. In contrast, a floating exchange rate is determined by market forces, allowing it to fluctuate based on supply and demand dynamics. This variability can create opportunities for traders to profit from short-term movements, but it also introduces a level of risk, as sudden changes in exchange rates can impact the profitability of international transactions. Understanding the nature of these exchange rate systems is essential for anyone involved in forex trading, as it influences their strategies and risk management approaches. In the next section we will discuss the different exchange rate regimes.

1.3 Exchange rate regimes

Exchange rate regimes play a crucial role in a country's economic stability and international trade dynamics. Each regime has its own set of advantages and disadvantages, influencing how countries manage their currencies in response to global market conditions. For instance, a fixed

exchange rate can provide stability and predictability for international transactions, but it may also limit a country's ability to respond to economic shocks.

Conversely, a floating exchange rate allows for greater flexibility and responsiveness to market forces, but it can lead to volatility that may deter foreign investment. Understanding these regimes is essential for policymakers and investors alike, as they navigate the complexities of global finance and strive to achieve economic growth.

Nations have varying systems of currency exchange. The exchange rate regimes include fixed or pegged, semi-fixed, and floating systems. In this context, it is important to recognize that the choice of exchange rate regime is often influenced by a country's economic structure, trade relationships, and overall financial stability.

For example, countries with strong export sectors may prefer a fixed or semi-fixed exchange rate to ensure price stability and predictability for their trading partners. On the other hand, nations with more diversified economies might opt for a floating exchange rate to allow for greater adaptability to changing global market conditions. Ultimately, the decision regarding which exchange rate regime to adopt is a complex one, requiring careful consideration of both domestic economic goals and international obligations. These regimes are discussed in the sections that follow.

- **A fixed or pegged exchange rate system**

In a fixed or pegged exchange rate system, a country chooses to keep its currency's value stable by tying it to another currency at a constant rate. This means that the exchange rate does not fluctuate, instead, it remains the same over time. The value of the currency that is used as the reference is usually determined by the economic conditions and decisions of the country whose currency it is. By maintaining this fixed exchange rate, the country aims to prevent any potential increases in debt repayments that could occur if its own currency were to depreciate. Typically, the currency that is pegged is one that belongs to a major trading partner or a significant creditor. This strategy is often employed to promote economic stability and predictability in international trade and finance.

- **Semi-Fixed Exchange Rate (Rate That is Only Partly Fixed)**

In a semi-fixed exchange rate system, the value of a nation's currency can fluctuate but only within specific predetermined limits, often referred to as target zones. This structure allows for some

flexibility while still maintaining a degree of stability in the exchange rate. The primary distinction between a semi-fixed exchange rate and a fully fixed one lies in the level of commitment that the central bank displays in achieving its established target. When the exchange rate approaches the upper or lower limits of these target zones, the central bank takes action, typically by adjusting interest rates. This adjustment is an essential tool; for instance, if the central bank raises interest rates, it attracts foreign capital, which tends to strengthen the local currency. Conversely, if it lowers interest rates, the opposite effect may occur, resulting in a weaker local currency. The implementation of a target zone not only provides a framework for managing the exchange rate but also grants the central bank the necessary flexibility to choose an exchange rate that aligns with its broader economic objectives and strategies.

- **Free or Floating Exchange Rate**

In the context of a free or floating exchange rate, the value of currency is determined by the natural forces of supply and demand present in the marketplace. This system operates on the principle that when there is a scarcity of a particular currency, its value is likely to rise due to increased demand. Conversely, if there is an excess or overflow of that currency, its value tends to decrease as demand wanes. Essentially, the fluctuations in currency values are a direct reflection of how much of that currency is available and how many people wish to acquire it at any given moment.

To accurately gauge the health of a country’s currency and its exchange rates, the balance of payments account plays a crucial role. This account meticulously records the flow of foreign capital in and out of the country, thus providing insight into the supply and demand dynamics that influence currency values. When examining these factors, it becomes clear that various economic indicators such as wage growth, inflation rates, and interest rates can significantly affect exchange rates. Changes in these areas can lead to a ripple effect, potentially altering the currency's value in the international marketplace.

However, it is important to note that despite the theoretical concept of fully floating exchange rates, very few currencies truly operate under a completely laissez-faire system. In practice, central banks often intervene in the foreign exchange markets to curb extreme fluctuations in exchange rates, as these drastic changes can have profound implications for international trade relations. Such interventions are aimed at maintaining a level of stability in the currency markets to promote confidence among traders and investors.

One of the primary challenges associated with a flexible exchange rate system is the phenomenon known as market contagion. This occurs when a significant event in one economy triggers a widespread reaction among investors, leading to uniform behavior that can result in a "run on a currency." A notable example of this effect was observed during the Asian financial crisis in 1997, where investors rapidly withdrew their capital from emerging markets, including South Africa. In response to the heightened instability and to protect the value of the rand, South Africa's central bank raised interest rates to an unprecedented 25%. This drastic measure, while aimed at stabilizing the currency, had detrimental consequences for South Africans, particularly for those with variable-rate loans, increasing their financial burden significantly.

This brings us to a central paradox within a flexible exchange rate system: the necessity for the central bank to frequently make decisions regarding monetary policy in order to ensure the stability of the currency. At the same time, the government may feel compelled to intervene by altering fiscal policies, such as adjusting tax laws, in an effort to attract foreign investment. This delicate balancing act highlights the complexities involved in maintaining a stable economic environment while allowing market forces to dictate currency values.

In addition to these challenges, the floating exchange rate system can also lead to increased uncertainty for businesses engaged in international trade. Companies may find it difficult to predict costs and revenues when exchange rates fluctuate significantly, which can complicate pricing strategies and profit margins. To mitigate this risk, many businesses turn to financial instruments such as forward contracts or options, allowing them to lock in exchange rates for future transactions. However, these hedging strategies come with their own costs and complexities, which can further strain resources, particularly for smaller firms. As a result, while a floating exchange rate system offers flexibility, it also necessitates a robust risk management approach to navigate the inherent volatility and protect against potential adverse impacts on trade and investment.

To conclude, understanding the various exchange rate regimes—fixed, semi-fixed, and floating—is essential for grasping the intricacies of global finance and the economic strategies nations employ. Each regime offers distinct advantages and challenges, influencing not only a country’s economic stability but also its international trade relations and attractiveness to foreign investment. As policymakers and investors navigate these dynamics, they must consider how each exchange rate system aligns with their specific economic goals and the broader impact on the global market.

Ultimately, the choice of an exchange rate regime is a pivotal decision, shaping a nation's economic environment and its role in the interconnected world economy. Navigating these complexities successfully requires a careful balance of economic insight, policy implementation, and a keen awareness of global market trends.

1.4 ISO Codes and Swift

The ISO codes serve as a universal language for currencies, facilitating seamless communication and transactions across borders. Each currency code is derived from the first two letters of the country name, followed by the first letter of the currency itself, ensuring consistency, and reducing confusion in international trade. For instance, the code for the South African rand (ZAR) is derived from the Dutch name for the country, "Zuid-Afrika," while the US dollar (USD) reflects its country of origin directly. This standardized system not only aids in the identification of currencies but also plays a crucial role in the automation of trading systems, where accurate and rapid processing of transactions is essential.

The International Symbol for Money (ISBN) is a three-letter designation that all currencies use when trading foreign exchange. For confirmation and payment messages to be sent between financial institutions using the SWIFT system, this is necessary. Some of the most common currencies' ISO codes are included in the table below.

Currency	ISO code
South African rand	**ZAR**
US dollar	**USD**
Japanese yen	**JPY**
British pound	**GBP**
Euro	**EUR**

Currency pairs represent the value of one currency in relation to another, and they are categorized into three main types: major pairs, minor pairs, and exotic pairs. Major pairs, such as EUR/USD and USD/JPY, involve the most traded currencies and typically have the highest liquidity.

Minor pairs, which do not include the US dollar, like EUR/GBP or AUD/NZD, tend to have lower trading volumes.

Exotic pairs, on the other hand, consist of a major currency paired with a currency from a developing economy, such as USD/TRY (Turkish Lira) or USD/ZAR (South African Rand). Each type of pair presents unique opportunities and risks, making it crucial for traders to understand their characteristics and market behavior.

The International Association for the Promotion of Good Practice in the Foreign Exchange and Money Markets, which is also known by its French name, Association Cambiste Internationale or ACI, strongly encourages professional dealers who work within these markets to follow the guidelines set forth by the organization. These recommendations are intended to promote best practices among professionals in the field, ensuring that they operate in a manner that is ethical, effective, and beneficial to the overall stability and integrity of the financial markets.

2. FOREX QUOTATIONS AND PRICING

2.1 Percentage in point

In the world of foreign exchange trading, a key term that you will come across is "pip." This term is an abbreviation for "percentage in point," and it is commonly referred to as "points" in some contexts. To put it simply, a pip represents the smallest price movement that can occur in a currency pair. For the South African rand (ZAR), one pip corresponds to the fourth decimal place of the currency. This means that a pip is equal to 0.0001 of a rand or, in other terms, it is 1/10,000 of the rand value, which is also equivalent to 1/100th of a cent. Understanding this concept is crucial for traders as it helps them measure and quantify price changes in the forex market.

Percentage in point (pip) is a critical concept in forex trading, as it allows traders to measure price movements with precision. Each pip represents a standardized unit of change in the exchange rate, which is essential for calculating profits and losses. For example, if a trader buys a currency pair at a certain price and later sells it at a higher price, the difference in pips can be used to determine the financial outcome of the trade. Understanding how to read and interpret pips is vital for traders, as it directly impacts their decision-making process and overall trading strategy. By keeping track of pip movements, traders can better manage their risk and optimize their trading performance.

The reason pips are used in currency markets is that exchange values typically vary in one-pip increments, and banks and other forex traders can quickly assess their gains or losses in this way.

A one-pip (ZAR 0,0001) movement in a USD/ZAR 7,0000 deal, for instance, would be worth ZAR 7,000 in a ZAR/USD 10 million trade.

2.2 Direct and Indirect Quotations

- **Direct Quotations**

A direct quotation against the US dollar, often abbreviated as USD, is represented in a way where you can see the exchange rate expressed in terms of local currency units per one US dollar. For example, if you see a quote that reads USD/ZAR 7.4500, this means that it takes approximately 7.45 South African Rand (ZAR) to equal one US dollar. This type of quotation is commonly used in financial markets and makes it easy for individuals and businesses to understand how much local currency they need to exchange to obtain a dollar.

Direct quotations express the value of a foreign currency in terms of the domestic currency, making it easier for traders and investors to understand the cost of purchasing foreign assets. For example, when a trader sees a direct quote of USD/JPY 110.00, it indicates that one US dollar can be exchanged for 110 Japanese yen. This method is particularly useful for individuals and businesses engaged in international trade, as it provides a clear and immediate understanding of currency value fluctuations. Conversely, indirect quotations serve the opposite purpose, allowing market participants to gauge how much of the foreign currency is needed to acquire one unit of the domestic currency, which can be beneficial for assessing the relative strength of the domestic economy.

It is common to use USD as the main currency and other currencies as the variable ones. There are different ways to show exchange rates. For example, GBP/USD 1.6550 means you can buy one GBP for 1.6550 USD.

- **Indirect Quotations**

On the other hand, an indirect quotation against the US dollar presents the exchange rate in a different format. For instance, if you come across a quote like CHF/USD 0.1342, this indicates the amount of US dollars needed to purchase one Swiss franc (CHF). In this case, it takes about 0.1342 US dollars to equal one Swiss franc. Indirect quotations are important for comparing the values of different currencies against the US dollar and are widely used in global finance.

Understanding these quotation methods is crucial for traders, as they can significantly impact trading strategies and decisions. For instance, a trader who primarily deals in USD may prefer direct quotations to quickly assess the cost of foreign currencies, while those focusing on local currencies might find indirect quotations more relevant. Additionally, fluctuations in exchange rates can lead to varying profit margins, making it essential for market participants to stay informed about both types of quotations. By mastering these concepts, traders can better navigate the complexities of the foreign exchange market and make more informed investment choices.

Most currencies, about 185, use direct quotes against the USD. However, there are some exceptions:

- UK pound sterling (GBP), for example, GBP/USD 1.6550.
- New Zealand dollar (NZD), like NZD/USD 0.7338.
- Australian dollar (AUD), as in AUD/USD 1.1005.
- Euro (EUR), such as EUR/USD 1.3425.

2.3 Inverse or reciprocal quotations

In the context of inverse quotations, it is important to note that this method allows traders to view the exchange rate from a different perspective, which can be particularly useful in certain trading strategies. For example, when analyzing the ZAR/USD 0.1342 quote, traders can quickly determine how many US dollars they would receive for a specific amount of South African rand. This approach not only aids in making informed decisions but also enhances the understanding of market dynamics, as fluctuations in the inverse rates can signal shifts in economic conditions or investor sentiment. By incorporating inverse quotations into their analysis, traders can gain a more comprehensive view of the currency market and adjust their strategies accordingly.

Moreover, inverse quotations can also play a significant role in risk management for traders. By understanding how to interpret these rates, traders can better hedge their positions against adverse currency movements. For instance, if a trader anticipates a strengthening of the South African rand against the US dollar, they might use the inverse quotation to calculate potential gains or losses on their investments. This proactive approach allows for more strategic planning and can help mitigate risks associated with currency volatility. As such, incorporating inverse quotations

into trading strategies not only enhances market analysis but also empowers traders to make more calculated decisions in the ever-changing landscape of foreign exchange.

2.4 Bids and Offers

In the foreign exchange market, understanding the dynamics of bids and offers is crucial for traders and investors alike. The bid price reflects the maximum price that a buyer is willing to pay for a currency, while the offer price represents the minimum price that a seller is willing to accept. This spread between the bid and offer prices is a key indicator of market liquidity and can vary based on factors such as market demand, economic news, and geopolitical events. Traders often analyze these prices to make informed decisions about when to enter or exit a position, as even small fluctuations can significantly impact profitability.

Understanding the bid and offer prices is essential for traders to gauge market sentiment and potential price movements. For instance, a narrowing spread may indicate increasing demand for a currency, suggesting that traders are becoming more optimistic about its future performance. Conversely, a widening spread can signal uncertainty or a lack of liquidity, prompting traders to exercise caution. By closely monitoring these fluctuations, traders can better position themselves to capitalize on market opportunities or mitigate risks associated with adverse price movements.

In the context of foreign exchange, the way a bank expresses its readiness to buy a particular amount of the base currency in exchange for a certain quantity of term currency is conveyed through something known as the bid. This bid is typically the first figure that is presented when you see a two-way price quotation. On the other hand, the second number that you see in this price quotation is referred to as the offer price. This offer price signifies the bank's readiness to sell the base currency for a specific amount of the term currency. In summary, the bid indicates the buying price for the base currency, while the offer price denotes the selling price for the same currency.

USD/ZAR quote of 7.3400/7.3500:

The price a bank pays to buy the base currency is on the left side of the slash. The price it charges to sell the base currency is on the right side.

In this case, the bank will pay ZAR 7.3400 to buy the base currency and ZAR 7.3500 to sell it. Some vendors might call these prices bid and ask.

3. FOREX TRANSACTIONS AND CALCULATIONS

3.1 Converting amounts in base and variable currencies

When dealing with currency conversions, it is essential to understand the roles of base and term currencies in the transaction. The base currency is the one being bought or sold, while the term currency is the one being exchanged for it. This distinction is crucial because it determines which side of the exchange rate to use. For instance, if an investor is looking to convert a specific amount of the term currency into the base currency, they must apply the bid rate, as this reflects the price at which the bank is willing to buy the base currency from the investor. Conversely, when purchasing the term currency, the ask rate is applied, indicating the price at which the bank will sell the base currency to the investor. Understanding these principles ensures accurate conversions and helps investors make informed decisions in the foreign exchange market.

To further illustrate the importance of understanding bid and ask rates, consider a scenario where an investor is looking to convert a smaller amount, such as 1 million ZAR into USD. In this case, the investor would need to refer to the ask rate provided by the broker, which reflects the price at which the broker is willing to sell USD in exchange for ZAR. If the ask rate is 5.4145, the calculation would be straightforward: 1 million ZAR divided by 5.4145 would yield approximately 184,000 USD. This example highlights how even minor transactions require careful attention to the exchange rates to ensure that the investor receives the correct amount in the desired currency.

In addition to understanding the bid and ask rates, it is also important for investors to be aware of the potential impact of market fluctuations on their currency conversions. Exchange rates can be highly volatile, influenced by various factors such as economic indicators, geopolitical events, and market sentiment. For instance, if an investor decides to wait for a more favorable exchange rate before converting their currency, they may benefit from a lower cost in the term currency. However,

this strategy also carries the risk of the rate moving against them, resulting in a higher cost than initially anticipated. Therefore, having a clear strategy and staying informed about market trends can significantly enhance an investor's ability to make profitable currency conversions.

When working with currencies that are listed in base and term values, it is common to convert the amounts from the base currency to their respective amounts in the term currency. This conversion is typically done by multiplying the amount in the base currency by the appropriate exchange rate value located on the right side of the exchange rate listing.

To illustrate this point with a practical example, let us consider a scenario where a dealer quotes an exchange rate of USD/ZAR as 7.1980/7.11985. An investor is interested in purchasing 10 million USD and selling a corresponding amount of 10 million ZAR. A question arises about how many ZAR the investor will ultimately need to pay to acquire the desired amount of USD.

In this situation, since the investor is purchasing the base currency—which, in this case, is USD, the applicable rate for the transaction is the offering rate found on the right side of the exchange rate. Therefore, to calculate the total amount to be paid in ZAR, the investor must multiply the amount of USD being acquired, which is 10 million, by the offering rate of 7.1985. This results in a total payment of 71,985,000 ZAR.

It is worth noting that in the foreign exchange market, it is standard procedure to take the amount in the term currency and divide it by the right side of the exchange rate in order to convert it back into the base currency. This practice ensures accuracy and clarity in currency conversion transactions.

3.2 Bid offer and spread

The bid offer spread is a crucial concept in foreign exchange trading, as it directly impacts the profitability of trades. When traders enter the market, they must be aware of the spread, as it represents the cost of executing a trade. A narrower spread typically indicates a more liquid market, where buyers and sellers can transact more easily, while a wider spread may suggest lower liquidity or higher volatility. Understanding the factors that influence the spread can help traders make more informed decisions and optimize their trading strategies.

The spread is the difference between the dealer's bid and offer prices. Banks make money when they buy and sell foreign currencies by getting them at a lower rate than the price, they are selling them for. Many things affect the spread, including:

- The standard in a certain market.
- The current level of liquidity in that currency pair.
- The market's instability.
- The amount that was offered.
- The client or counterparty.

3.3 Cross Rate

Cross rates play a crucial role in the foreign exchange market, as they allow traders to determine the value of one currency in terms of another without directly involving the USD. This is particularly useful for investors and businesses operating in countries where the local currency is not widely traded or lacks sufficient liquidity. By utilizing cross rates, market participants can make informed decisions about currency conversions, hedging strategies, and international transactions. Understanding how to accurately calculate these rates is essential for anyone looking to navigate the complexities of global finance effectively.

When looking at currencies that are not the USD, we compare them to the USD to find rates and prices. The result of this comparison is called a cross-rate. A cross-rate shows the exchange rate between two currencies that are not the USD.

We often find cross rates by looking at how two or more currencies are priced against the US dollar.

It is important to choose the right method to calculate cross-currency rates. This choice depends on how the two currencies are valued in relation to the dollar.

A South African buyer wants to borrow $1 million from a bank. The bank's rates are between 6.5230 and 6.5280 ZAR per USD. Since the dealer is buying USD and selling ZAR, the rate is R6.5280. The dealer will pay R6,528,000, which is $1,000,000 times R6.5280.

A South African trader wants to sell the bank $1 million. The bank will use the bid rate of R6.5230 because it is buying USD and selling ZAR. The seller will get R6,523,000, which is $1,000,000 R6.5230.

The bank makes money from the difference in these prices. The difference is R5,000, which is R6,528,000 minus R6,523,000.

The United States Dollar (USD) is often referred to as the "vehicle currency" due to its widespread use by countries around the globe for trading and exchanging their own currencies. This unique status means that when you look up currency exchange rates, you will frequently see pairs such as USD/ZAR (South African Rand), USD/MWK (Malawi Kwacha), USD/RUB (Russian Rouble), and USD/UYP (Uruguayan Peso). However, it is important to note that you typically will not find direct exchange rates for other combinations like ZAR/UYP, ZAR/MWK, or even GBP/ZAR (British Pound to South African Rand). This indicates that the USD serves as a common intermediary through which international trade takes place.

In particular, there are several key points to consider regarding this situation:

One significant aspect is that many of the smaller countries across the world do not engage in trading activities using their own currencies. Instead, they rely on the USD as a stable alternative for transactions. This practice has been the norm for a long time within the interbank foreign exchange market, where currencies are predominantly traded against the USD. This trading practice helps to avoid the complications that could arise from having numerous varying exchange rates and prices among the currencies of smaller countries. Currently, the International Organization for Standardization (ISO) has assigned unique codes to approximately 190 different currencies for clarity and consistency in international transactions.

Moreover, if currencies were allowed to trade directly with one another, without the USD as the intermediary, the liquidity in those markets would likely be exceptionally low. Liquidity, which refers to how easily assets can be bought or sold in the market without affecting the asset's price, is significantly bolstered when currencies are traded against the USD. This arrangement contributes to a more efficient pricing system for rates between non-USD currencies, making the overall market for foreign exchange transactions more effective.

In the context of cross rates, it is essential to understand the mechanics behind how these rates are derived, as they can significantly impact trading strategies and financial decisions. For instance, when calculating a cross rate, traders must consider the relative strength of the currencies involved, as well as any economic indicators or geopolitical factors that may influence their value. This analysis not only aids in determining the most favorable exchange rates but also helps in assessing potential risks associated with currency fluctuations. By staying informed about

market trends and employing effective calculation methods, traders can enhance their ability to navigate the complexities of the foreign exchange market and optimize their trading outcomes.

- **The base and counter currencies in the two quotations are not the same**

The two quotations differ from each other due to the fact that they have different base currencies and counter currencies. This means that the first currency in each quote, which is known as the base currency, and the second currency, which is referred to as the counter currency, do not match up.

To determine the cross rate between these two quotes, you can multiply the bid rates of both exchange rates together. This will give you the bid rate of the cross rate, which is the appropriate calculation for this scenario. Similarly, if you want to find the offer rate for the cross rate, you will multiply the offer rates of the two exchange rates together.

- **Both the base and counter currencies of the two quotations differ**

The two quotes are different because their base and counter currencies are different.

Multiplying the bids of the two exchange rates yields the bid of the cross rate, which is the correct formula in this situation. In a similar vein. The cross rate is the result of multiplying the two offer rates.

- **Both quotes use the same base currency**

Here, we get the cross rate by splitting across, or from the bids and offers separately. The currency that is desired as the base currency for the cross rate is the denominator of the calculation.

- **Both quotations use the same counter currency**

The proper method, as mentioned before, is to divide up the bids one by one. The numerator of this cross-currency rate computation is the base currency that is desired this time.

4. APPRECIATION AND DEPRECIATION IN FOREIGN EXCHANGE RATES

The fluctuations in foreign exchange rates can significantly impact international trade and investment decisions. For instance, when a currency appreciates, it can make exports more

expensive and imports cheaper, potentially leading to a trade deficit. Conversely, if a currency depreciates, it can boost exports by making them more competitively priced in foreign markets while increasing the cost of imports. This dynamic can influence a country's economic health, as businesses and consumers adjust their purchasing behaviors based on the relative strength of their currency. Understanding these implications is crucial for businesses engaged in international trade, as they must navigate the complexities of currency movements to optimize their pricing strategies and maintain profitability.

The way an exchange rate is presented may not seem significant initially. However, it is important because the market uses terms like currency appreciation and depreciation, which can be confusing if not managed properly.

Some individuals might mistakenly believe that the South African rand, often abbreviated as ZAR, has actually strengthened, or appreciated when they observe a change in the USD/ZAR exchange rate moving from USD/ZAR 10.00 to USD/ZAR 10.20. However, this interpretation is somewhat misleading. To clarify, in the initial scenario where the rate was USD/ZAR 10.00, it required ten South African rands to purchase one US dollar. When the exchange rate shifted to USD/ZAR 10.20, it still takes ten South African rands to buy the same one US dollar; however, the implication here is that the purchasing power of the South African rand has diminished. This indicates that the value of the US dollar has increased relative to the value of the ZAR, which means the South African rand has effectively lost its worth.

To further explain, when we look at the inverse of these two currency rates, we can see the values presented as ZAR/USD 0.1000 and ZAR/USD 0.0980, respectively. Here we can observe that in both cases, acquiring US dollars using South African rand yields a lesser amount than what was available in the first scenario. This demonstrates that, in comparison to the US dollar, the South African rand has indeed lost value, while conversely, the US dollar has gained strength. Such fluctuations in exchange rates are important to comprehend, as they directly reflect the relative purchasing power of different currencies in the global market.

In this context, it is important to understand that the currency which serves as the base, rather than the variable currency, is the one that experiences appreciation or depreciation. In the example provided, the US dollar is identified as the base currency, which serves as a point of reference for the variable currency, which in this case is the South African rand. The timeframe over which this

financial transformation occurs is an essential aspect that is addressed in the second argument presented. It is noteworthy to mention that the value of the US dollar has indeed risen during the interval between the points at which the South African rand was recorded at an exchange rate of USD/ZAR 10.00 and subsequently at USD/ZAR 12.50. This change does not occur instantaneously; rather, it unfolds over a period of several days, weeks, or even months. Therefore, it is more precise to characterize this phenomenon as a gradual shift or change that occurs over time, as opposed to an annual rate of change that might suggest a more consistent or uniform fluctuation

6. WHY RATES OF EXCHANGE MATTER

Exchange rates play a pivotal role in shaping the economic landscape of nations, influencing everything from consumer prices to international competitiveness. When the currency strengthens, it can lead to a decrease in export demand as foreign buyers find local goods more expensive, while imports become cheaper, potentially harming domestic producers. Conversely, a weaker currency can enhance export competitiveness, making local products more attractive to foreign markets, but it can also inflate the cost of imported goods, leading to higher prices for consumers. This delicate balance underscores the importance of monitoring exchange rate movements, as they can have far-reaching implications for trade balances, inflation rates, and overall economic growth. Understanding these dynamics is essential for policymakers and businesses alike, as they navigate the complexities of a globalized economy.

Exchange rates are important because they change how much things from other countries cost and how much investments are worth. It is clear that the price of US goods for a local buyer depends on two things:

- How much the things cost in US dollars?
- The rate of exchange between USD and ZAR.

A Samsung Tablet that costs 2000 dollars in the US will cost 20,000 naira in Nigeria. This is because the exchange rate is 10 naira for 1 dollar.

If a buyer waits three months and the exchange rate changes to 10.5 naira for 1 dollar, the tablet will then cost 21,000 naira (2000 times 10.5 naira). This assumes the price in dollars stays the same.

Similarly, if someone in the US waits to buy a PlayStation 5 for three months, they could save 500 dollars. At the start, the PS5 costs 10,000 rand (based on the exchange rate). After three months, the price in rand might be 9500 dollars, showing they saved money.

In summary, when the value of the rand goes down, prices for American goods go up in South Africa, while prices for local goods in the US go down.

People came to the conclusion that when a country's currency falls in value, its things become cheaper in other countries and more expensive in the home country.

When a country's currency loses value, its products become cheaper for other countries and more expensive at home.

If a country's currency increases in value, its products cost more in other countries and less in the home country. So, if the South African Rand (ZAR) goes up, it makes it hard for local producers to compete. South Africa struggles against countries whose currencies have not risen. South African products become pricier abroad, while foreign goods get cheaper in South Africa. This leads to more imports and cheaper travel for South Africans to other countries. But this situation will not last forever, and the ZAR will eventually lose value again.

Exchange rates hold significant importance in the global economy as they directly influence the prices of goods and services from other countries as well as the value of investments made abroad. When we consider the cost of products from the United States for a buyer located in South Africa, it is evident that two key factors play a vital role in determining the final price:

• The initial price of the goods when expressed in US dollars.

• The current exchange rate that exists between the US dollar (USD) and the South African rand (ZAR).

7. THEORETICAL FRAMEWORK FOR DETERMINING EXCHANGE RATES

In the realm of foreign exchange, various factors contribute to the determination of exchange rates, including economic indicators, geopolitical events, and market sentiment. For instance, a country's interest rates can significantly influence its currency value; higher interest rates typically attract foreign capital, leading to currency appreciation, while lower rates may result in depreciation. Additionally, political stability and economic performance play crucial roles, as investors tend to favor currencies from countries with strong, stable economies. Understanding these elements is essential for traders and investors, as they navigate the complexities of the forex market and make informed decisions based on the interplay of these factors.

- **Purchasing Power Parity**

Purchasing power parity (PPP) serves as a theoretical framework that helps to explain how exchange rates should adjust based on the relative price levels of two countries. It posits that in the long run, identical goods should have the same price when expressed in a common currency, assuming no transportation costs or trade barriers. For example, if a basket of goods costs $100 in the United States and the same basket costs €90 in Europe, PPP suggests that the exchange rate should adjust to reflect this price difference, ideally leading to a rate of $1.11 per euro. However, in practice, various factors such as market inefficiencies, government interventions, and differing consumption patterns can lead to deviations from this ideal, making PPP a useful but imperfect tool for predicting exchange rate movements.

Purchasing power parity (PPP) is a theory about how current and future exchange rates relate to each other. It focuses on differences in inflation. Because inflation rates change and future spot rates are uncertain, PPP is not limited by trading rules. Instead, it helps show how exchange rates might move over longer periods.

PPP suggests that the same goods and services should cost the same in different countries. By comparing prices in different places, we can estimate exchange rates. For example, if a liter of milk costs $1 in the US and €0.90 in France, PPP says the exchange rate should be either $1 = €0.90 or €1 = $1.11. If milk costs only €0.80 in France, it would be cheaper to buy it there than in the US. US importers could buy milk for €0.80 (about $0.89) and sell it for $0.90, making a small profit.

This buying and selling to profit from price differences is called arbitrage.

Despite its theoretical appeal, purchasing power parity (PPP) often fails to hold true in real-world scenarios due to various market frictions and external factors. For instance, transportation costs, tariffs, and differences in consumer preferences can create significant price disparities between countries, leading to deviations from the expected exchange rates predicted by PPP. Additionally, short-term fluctuations in currency values can be influenced by speculative trading, geopolitical events, and economic announcements, which may not align with the long-term price adjustments that PPP suggests. As a result, while PPP provides a useful framework for understanding exchange rate movements over extended periods, it is essential for investors and policymakers to consider these real-world complexities when making decisions based on currency valuations.

- **Balance of payments**

The balance of payments framework highlights the interconnectedness of a country's economic activities with the global market, emphasizing how trade deficits or surpluses can influence currency values. When a nation experiences a persistent current account deficit, it indicates that its imports exceed exports, leading to a higher demand for foreign currencies to pay for those imports. This increased demand can put downward pressure on the domestic currency, prompting a depreciation that makes imports more expensive and exports cheaper. Conversely, a current account surplus, where exports outpace imports, can strengthen the domestic currency as foreign buyers seek to purchase local goods. Thus, the balance of payments not only reflects a country's economic health but also serves as a critical determinant of exchange rate movements, influencing both short-term trading strategies and long-term investment decisions.

The exchange rate can change to balance payments between two countries. This is especially true for the current account.

If a country buys more than it sells to others, its currency should lose value. This will make imports cost more, which could lead to buying less from abroad. At the same time, a weaker currency makes exports cheaper, which can boost demand from other countries. These two effects should help fix the current deficit.

Some countries might choose to lower their currency value on purpose to help their economy grow.

This idea is not immensely helpful for understanding exchange rates in the short term, but it may apply in the long run.

- **Principle of interest rate parity**

The principle of interest rate parity (IRP) is crucial for understanding how interest rates affect exchange rates and vice versa. It posits that the difference in interest rates between two countries will be reflected in the forward exchange rates of their currencies. For example, if South Africa has a higher interest rate compared to the United States, investors will seek to invest in South African assets to take advantage of the higher returns. This increased demand for the South African rand (ZAR) will lead to its appreciation against the US dollar (USD) in the forward market. Conversely, if the interest rates in South Africa decrease or if the US rates increase, the ZAR may depreciate as investors shift their capital to the US for better returns. Thus, understanding IRP helps investors anticipate currency movements based on interest rate changes, which is essential for making informed investment decisions in the foreign exchange market.

According to the interest rate parity principle, the net return from an offshore investment should match the interest earned, adjusted by the forward discount or premium of the foreign currency.

This means that interest rate parity is achieved when the difference in interest rates is equal to the currency's forward discount or premium. There is a connection between the interest rate difference and the forward discount or premium.

Arbitrage helps keep the forward market in this balanced state.

When interest rates in South Africa go up faster than in the United States, the forward rate will be higher than the spot rate. This happens because the ZAR (South African Rand) increases more quickly than the USD (U.S. Dollar).

However, this idea is not especially useful in real life. Data often shows that this theory is not correct.

- **Interest rate differentials and inflation**

Interest rate differentials play a crucial role in shaping currency values, as they reflect the relative attractiveness of investing in one currency over another. When a country offers higher interest rates compared to its trading partners, it tends to attract foreign capital, leading to an appreciation of its currency. Conversely, if interest rates are lower, investors may seek better returns elsewhere, resulting in depreciation. This dynamic is particularly evident in emerging markets, where fluctuations in interest rates can lead to significant capital inflows or outflows, thereby impacting exchange rates. Understanding these relationships is essential for investors and policymakers, as they navigate the complexities of the foreign exchange market and make informed decisions based on interest rate trends and their implications for currency valuation.

- **Interest rate factors**

Interest rate differentials are a key driver of currency fluctuations, as they reflect the relative attractiveness of investing in one currency over another. When a country raises its interest rates, it often leads to an influx of foreign capital seeking higher returns, which can result in an appreciation of that country's currency. Conversely, if a country lowers its interest rates, it may deter foreign investment, leading to depreciation. This relationship is particularly evident in emerging markets, where even small changes in interest rates can trigger significant capital movements and impact exchange rates. Therefore, understanding the dynamics of interest rate differentials is essential for investors and policymakers, as they navigate the complexities of the foreign exchange market and make informed decisions based on these trends.

The nominal interest rate is the real interest rate plus the expected inflation rate. This is based on the Fisher Effect. You can think of it like this:

(1 + nominal rate) = (1 + real rate) + (1 + expected inflation rate).

This estimate is based on the idea that the cross-product term is generally small and can be ignored. It states that the real rate plus expected inflation equals the nominal rate.

The expected inflation minus the nominal rate gives us the real rate.

The value of a country's currency can increase when there is a growing interest from foreign investors who wish to purchase its financial securities. This phenomenon tends to be especially significant in nations that offer high real rates of return. High real rates of return are characterized

by a substantial difference between the nominal interest rates and the rates of inflation. When foreign investors perceive that they can obtain better returns on their investments in a particular country, they are more likely to buy its currency to invest in the available securities, leading to an appreciation in its value.

8. FUNDAMENTALS VS TECHNICAL ANALYSIS

In the realm of foreign exchange, traders and investors often rely on a combination of fundamental and technical analysis to make informed decisions. Fundamental analysis focuses on economic indicators, interest rates, and geopolitical events that can influence currency values, while technical analysis examines historical price movements and trading volumes to identify patterns and trends. By integrating both approaches, market participants can gain a comprehensive understanding of the factors driving currency fluctuations, allowing them to better anticipate potential market movements and adjust their trading strategies accordingly. This dual approach not only enhances decision-making but also helps mitigate risks associated with the inherent volatility of the forex market.

A bond or stock's expected cash flows are key to fundamental analysis, which helps with investment choices. In foreign exchange, fundamental analysis focuses on the economic factors that affect the demand and supply for a currency. It starts with big picture items like growth, inflation, interest rates, and government policies, then looks at smaller details like supply and demand.

For investment decisions, technical analysis is also important. It looks at price, volume, and momentum patterns of a currency over time. There are different theories to guide technical analysis. A key idea is that all types of information, both public and private, affect stock prices over time.

9. HEDGING AND SPECULATING IN THE FOREIGN EXCHANGE MARKET

Hedging and speculating are two distinct strategies employed by investors in the foreign exchange market, each with its own objectives and methodologies. Hedging is primarily focused on risk management, allowing investors to protect their portfolios from adverse price movements by taking positions that offset potential losses. For example, a company expecting to receive payments in a foreign currency may enter into a forward contract to lock in an exchange rate,

thereby mitigating the risk of currency fluctuations. On the other hand, speculation involves taking calculated risks to profit from anticipated changes in exchange rates. Speculators analyze market trends and economic indicators to make informed predictions about future currency movements, aiming to capitalize on these fluctuations for financial gain. Understanding the differences between these two approaches is essential for market participants, as it influences their trading strategies and risk tolerance in the dynamic forex landscape.

Hedging strategies can take various forms, including options, futures, and forward contracts, each designed to mitigate the risks associated with currency fluctuations. For instance, a company that anticipates receiving payments in a foreign currency may opt for a forward contract to lock in a specific exchange rate, thereby safeguarding its profit margins against adverse movements in the currency market. Similarly, options provide the flexibility to buy or sell a currency at a predetermined rate, allowing businesses to manage their exposure while retaining the potential for favorable market conditions. By employing these hedging techniques, investors and companies can effectively navigate the uncertainties of the foreign exchange market, ensuring greater stability in their financial operations.

Hedging helps reduce the risk of changes in an asset's price, while speculation tries to make money from those changes.

Hedging often involves taking a position in a related financial product to balance out possible gains or losses. It aims to protect against price changes by opposing current investments.

On the other hand, speculation is about making money by guessing how the price of something will change in the future.

In conclusion, understanding the various concepts and strategies within the foreign exchange market is crucial for both novice and experienced investors. The interplay between fundamental and technical analysis provides a comprehensive framework for making informed trading decisions, while the distinction between hedging and speculation highlights the diverse approaches investors can take to manage risk and pursue profit. Additionally, being aware of the fees and costs associated with trading foreign exchange is essential for optimizing investment returns.

As the forex market continues to evolve, staying informed about economic indicators, market trends, and trading strategies will empower investors to navigate this dynamic landscape effectively. By integrating knowledge of forex instruments, such as spot transactions and outright forwards, investors can enhance their trading strategies and achieve their financial goals in the ever-changing world of currency exchange.

CHAPTER 4: FOREX INSTRUMENTS

Learning outcomes:

By the end of this chapter, participants will be able to:

1. Define and explain spot transactions, including their characteristics and uses.
2. Describe outright forwards, including their advantages and disadvantages.
3. Explain foreign exchange swaps, including their structure and applications.
4. Understand futures contracts, including their characteristics, benefits, and limitations.
5. Describe options, including their types (call and put), characteristics, and uses.
6. Explain currency swaps, including their structure, benefits, and applications.
7. Understand deposit accounts for foreign currency, including their characteristics, benefits, and uses.

Forex instruments are essential tools for traders and investors looking to navigate the complexities of the foreign exchange market. These instruments allow participants to hedge against currency fluctuations, speculate on price movements, and manage their exposure to different currencies. Understanding the various types of forex instruments, such as spot transactions, forwards, swaps, futures, and options, is crucial for making informed trading decisions. Each instrument has its unique characteristics, risks, and benefits, which can significantly impact a trader's strategy and overall success in the forex market.

1. THE SPOT TRANSACTION

Spot transactions are the most straightforward forex instruments, allowing traders to buy or sell currencies at the current market price. This immediacy makes them particularly appealing for those looking to capitalize on short-term market movements. In a spot transaction, the exchange of currencies occurs almost instantly, which means that traders can quickly respond to market fluctuations. Additionally, spot transactions are typically used by businesses and individuals who need to convert currencies for immediate use, such as for travel or international purchases. Understanding the mechanics of spot transactions is essential for anyone looking to engage in forex trading, as they form the foundation upon which more complex instruments are built.

A spot transaction is when two currencies are exchanged at the current market rate.

The spot rate is for a short time, usually within two working days.

There are two market rates for a currency. The offer rate is the price to sell one currency for another. The bid rate is the price to buy one currency with another.

The bid rate is what the bank pays to buy USD and sell a different currency. The offer rate is what the bank charges to sell USD and buy another currency. The bank makes a profit from the difference between these two rates, known as the spread.

2. OUTRIGHT FORWARD

Outright forwards are particularly useful for businesses engaged in international trade, as they allow companies to lock in exchange rates for future transactions, thereby mitigating the risk of currency fluctuations. For instance, a company expecting to receive payments in a foreign currency in three months can enter into an outright forward contract to secure the current exchange rate, ensuring that they know exactly how much they will receive in their local currency when the payment is made. This predictability in cash flow can be crucial for budgeting and financial planning, making outright forwards a popular choice among exporters and importers alike.

An outright foreign exchange forward trade is like a spot transaction. It is a one-time trade of one currency for another.

A spot transaction must be completed within two business days from the deal date. In contrast, a forward transaction must be completed on a set date that is three or more business days after the deal date.

These trades are known as forward exchange contracts or forward contracts.

The spot exchange rate and the future exchange rate are usually different, but they can be the same. The difference between them shows the interest rate difference between currencies. If this difference did not exist, forward contracts could be used to make risk-free profits.

Prices for forward contracts are given as premiums or discounts to the spot rate, not as forward rates. A "point" is equal to 0.0001 of the currency. The forward rate is found by adding the premium or subtracting the discount from the spot rate for direct quotes. For indirect quotes, the process is reversed.

3. FOREIGN EXCHANGE SWAPS

Foreign exchange swaps are versatile instruments that allow traders to manage their currency exposure effectively. By engaging in a swap, parties can benefit from favorable interest rates and exchange rate movements while maintaining liquidity. This is particularly advantageous for multinational corporations that operate in multiple currencies, as it enables them to optimize their cash flow and reduce the costs associated with currency conversion. Additionally, swaps can be tailored to meet specific financial needs, making them a popular choice for both hedging and speculative purposes in the forex market.

Forex swaps involve exchanging two currencies at a fixed rate. Later, there is an agreement to exchange them again at the same rate, plus or minus swap points, on a future date.

For example, if a US bank needs short-term funds in Germany and wants to keep its Euros, it will buy EUR 1 million with USD and sell the Euros forward. This means the bank will have a EUR 1 million credit balance. After selling the same amount forward, it will have zero Euros left.

The base exchange rate for the "points" is usually close to the current rate.

Swap points are shown as 590 / 600.

This quote means:

- The left side (exchange rate + 590 / 10,000 points) is the price to buy USD 60 days from now.
- The right side (exchange rate + 600 / 10,000 points) is the price to sell USD 60 days from now.

Calculations:

- The difference between the outright forward and spot price is the forward swap points.
- To find the outright forward, add the spot price to the forward swap points.

4. FUTURE CONTRACTS

Futures contracts are standardized agreements to buy or sell a specific amount of a currency at a predetermined price on a specified future date. Unlike forward contracts, which are customized and traded over the counter, futures contracts are traded on exchanges, providing greater transparency and liquidity. This standardization means that futures contracts have set expiration dates and contract sizes, making them easier to trade and manage. Traders often use futures contracts to hedge against potential losses in the spot market or to speculate on future currency movements. The ability to leverage positions in futures trading can amplify both potential gains and losses, making it essential for traders to have a solid understanding of market dynamics and risk management strategies.

5. OPTIONS

Options in the forex market provide traders with the flexibility to manage their risk and capitalize on potential price movements without the obligation to execute the trade. A call option gives the holder the right, but not the obligation, to purchase a currency at a specified price within a certain timeframe, while a put option allows the holder to sell a currency under similar conditions. This unique feature makes options particularly appealing for those looking to hedge against adverse market movements or to speculate on future currency fluctuations. Additionally, options can be tailored to fit specific trading strategies, allowing traders to implement complex strategies such as straddles or spreads, which can enhance their potential for profit while managing risk effectively.

When someone buys a call option, they have the right to buy a certain amount of cash at a certain exchange rate on or before a certain date. When someone buys a put option, they have the right to

sell a certain amount of cash at a certain exchange rate on or before a certain date. You can trade options on an exchange or without an exchange.

Currency reference warrants, often abbreviated as CRWs, are a specific financial instrument that functions as a selling option for foreign currencies. These warrants are actively traded in the financial markets and provide investors with a unique way to speculate or hedge against currency fluctuations.

The CRWs are categorized as European-style options, which means they can only be exercised at the expiration date. They are available in two varieties: call options, which give the holder the right to buy a currency at a predetermined price and put options which grant the holder the right to sell a currency at a predetermined price. These instruments are officially listed on the Johannesburg Stock Exchange (JSE), and when they are exercised or settled, they result in a cash payment rather than the physical delivery of the underlying asset.

5. CURRENCY SWAP

Currency swaps can also be beneficial for companies looking to manage their foreign exchange risk while optimizing their capital structure. By entering into a currency swap, a company can effectively convert its debt obligations from one currency to another, allowing it to take advantage of lower interest rates or more favorable terms in the foreign market. This strategy not only helps in mitigating the risks associated with currency fluctuations but also enhances the company's ability to manage its cash flow more efficiently. Furthermore, currency swaps can be structured to align with the company's specific financial goals, making them a flexible tool in the realm of corporate finance.

When you engage in a currency swap, you are essentially trading not just the principal amounts involved but also the interest payments that are associated with those amounts, moving them from one currency to another. This means that you are exchanging cash flows that are denominated in one currency for an equivalent set of cash flows in a different currency, which may be beneficial for various financial strategies or needs.

In most situations, the amounts that are being swapped are typically of equal size. This means that when the exchange takes place, the principal amounts of the currencies being traded are generally equal, ensuring that the swap is balanced in terms of the monetary value being exchanged.

Additionally, interest payments are calculated and added to both ends of the transaction, influencing the overall terms and benefits of the swap agreement.

Currency swaps are unique financial instruments that are conducted without the involvement of a central bank, making them more flexible and directly negotiated between the parties involved. They bear similarities to interest rate swaps, yet the critical difference lies in the fact that with currency swaps, the principal amounts in different currencies are exchanged. This fundamental element of currency swaps allows for varied advantages, particularly in managing foreign exchange exposure.

The simplest form of a currency swap typically includes three distinct sets of cash flows that occur throughout the life of the swap agreement. First, there is the initial exchange of principal amounts when the swap is first initiated. Second, during the duration of the swap, the parties involved will make interest payments to each other according to the agreed terms. Finally, at the conclusion of the swap period, a final exchange of principal amounts takes place. It is important to note that both the first exchange and the last exchange of principals are conducted at the current spot exchange rate that is applicable on the date the deal is finalized. This ensures that both parties are operating under fair and equitable conditions.

A currency swap helps protect against exchange rate risk.

Companies often use money trades to safeguard against this risk. For instance, South African companies that send money abroad use currency swaps to reduce exchange rate issues when transferring funds. Here is a simple example to explain this better.

Imagine a company in the UK. It has no assets but owes GBP150 million. This includes GBP100 million in two-year fixed USD bonds with a 10% annual interest rate.

Now consider a U.S. company. It has all its money in USD but owes GBP100 million, which is USD150 million, from two-year fixed GBP bonds with a 10% annual interest rate.

After one year, the UK company gets worried that the GBP will lose value against the USD. This means paying off its debt may cost more later. At the same time, the U.S. company fears that the USD will lose value against the GBP, leading to higher debt costs.

Noticing these concerns, a dealer suggests a swap deal. The deal is set at an exchange rate of GBP/USD 1.5000. For this example, we will not include the dealer's profit.

- **Variations on the theme**

Currency swaps can also be structured to include options, allowing parties to have the flexibility to choose whether to execute the swap based on market conditions at the time of maturity. This hybrid approach can provide additional risk management benefits, as it allows companies to hedge against unfavorable movements in exchange rates while still retaining the potential to capitalize on favorable shifts. By incorporating options into currency swaps, businesses can tailor their financial strategies to better align with their specific risk profiles and market outlooks, ultimately enhancing their ability to navigate the complexities of international finance.

Two of the most fundamental variants are listed below:

• Swapping currencies: This trades one currency's variable rate for another's fixed rate. A cross between a currency swap and a standard interest rate swap, this is effectively what you get.

• Differential swap: This type of swap involves trading one country's floating rate for another's floating rate. The two payments are offset by a domestic hypothetical sum.

- **Investment Assets Denominated in Foreign Currency**

Investing in assets denominated in foreign currencies can provide significant opportunities for diversification and potential returns. By holding foreign currency assets, investors can benefit from favorable exchange rate movements, which may enhance the overall performance of their investment portfolio. Additionally, these assets can act as a hedge against domestic currency depreciation, offering a layer of protection during times of economic uncertainty. However, it is essential for investors to conduct thorough research and analysis to understand the risks associated with currency fluctuations, as well as the economic and political factors that may impact the value of foreign currencies. This strategic approach can help investors make informed decisions and optimize their investment outcomes in the global market.

When helping clients, both individuals and organizations, it is good to think about different types of investments. This includes bonds, real estate, foreign stocks, cash, and other options.

When we look at different types of investments like stocks, bonds, and real estate in foreign money, they all show similar levels of risk.

6. DEPOSIT ACCOUNT FOR FOREIGN CURRENCY

Foreign currency deposit accounts offer a unique opportunity for individuals and businesses to manage their foreign exchange exposure while earning interest on their deposits. These accounts allow account holders to hold funds in various currencies, which can be particularly beneficial for those who frequently engage in international transactions or travel abroad. By maintaining a balance in a foreign currency, individuals can avoid the risks associated with currency conversion at the time of purchase, potentially saving money if the exchange rate fluctuates unfavorably. Additionally, these accounts often come with competitive interest rates, providing an incentive for savers to keep their funds in foreign currencies rather than converting them to their local currency.

Foreign currency deposit accounts can also serve as a strategic tool for businesses engaged in international trade, allowing them to manage their cash flow more effectively. By holding funds in the currency of their trading partners, companies can streamline their operations and reduce the costs associated with currency conversion. This not only helps in mitigating the risks of exchange rate fluctuations but also enhances the company's ability to make timely payments to suppliers or receive payments from customers without incurring additional fees. Furthermore, these accounts can provide businesses with greater flexibility in managing their foreign currency exposure, ultimately contributing to improved financial stability and operational efficiency.

When you have a foreign currency deposit account, you can hold money in different currencies. The main ones are the US Dollar (USD), the British Pound (GBP), and the Euro (EUR).

People usually invest this way to save money for future purchases from other countries, like a trip, without worrying that the value of their money will change compared to the dollar.

In conclusion, forex instruments, including currency swaps and foreign currency deposit accounts, play a crucial role in the global financial landscape. They provide businesses and investors with essential tools to manage exchange rate risks, enhance investment opportunities, and optimize financial strategies. By understanding the various types of forex instruments and their functionalities, individuals and organizations can make informed decisions that align with their financial goals. As the international market continues to evolve, leveraging these instruments effectively will be key to navigating the complexities of foreign exchange and maximizing potential

returns. Embracing a strategic approach to forex instruments not only safeguards against volatility but also opens doors to new avenues for growth and stability in an interconnected world.

CHAPTER 5 : FEES CHARGES AND TAX

Learning outcomes:

By the end of this chapter, participants will be able to:

1. Identify and explain the different types of fees and charges associated with forex investments, including commission, spread, and swap fees.

2. Understand how fees and charges impact forex investment returns and how to minimize their impact.

3. Explain the tax implications of forex investments in South Africa, including the taxation of forex gains and losses.

4. Describe the role of the South African Revenue Service (SARS) in regulating forex investments and the tax obligations of forex investors.

Foreign exchange trading also incurs various fees that can significantly impact an investor's overall returns. These fees may include costs associated with currency conversion, which can vary depending on the broker and the specific currency pairs being traded. Additionally, there may be overnight financing fees, commonly referred to as swap rates, which are charged when positions are held overnight. These fees can either be positive or negative, depending on the interest rate differential between the two currencies involved in the trade. Understanding these additional costs is crucial for investors, as they can erode profits and should be factored into any trading strategy.

1. FEES AND CHARGES

Commissions charged by brokers

Brokers typically charge a commission based on the volume of trades executed, which can vary significantly depending on the broker's pricing structure and the type of account held by the investor. For instance, some brokers may offer a tiered commission structure where the fee per trade decreases as the trading volume increases, incentivizing higher trading activity. Additionally, there may be other costs associated with trading, such as account maintenance fees or inactivity fees, which can further affect an investor's bottom line. It is essential for traders to thoroughly review the fee schedule of their chosen broker to ensure they are fully aware of all potential costs involved in their trading activities.

Forex on-exchange trading necessitates the assistance of a broker who is an authorised user registered with the JSE. In order to cover the costs of processing the trade, brokers impose a commission or brokerage fee that varies with the amount of trades executed. Brokers charge different amounts. Retail customers making small-dollar transactions can take advantage of a bid/ask to spread of up to 2.5%. As a result of the significantly reduced brokerage cost, this spread will be significantly narrower for institutional investors.

Fees for managing a portfolio (Portfolio management fees)

Portfolio management fees can vary widely based on the services provided and the complexity of the investment strategy. Typically, these fees are expressed as a percentage of the assets under management (AUM) and can range from 0.5% to 2% annually. Some managers may also charge a flat fee or a combination of both, depending on the level of service and expertise required. It is important for investors to understand what is included in these fees, as some managers may offer additional services such as financial planning or tax advice, which can justify higher fees. Transparency in fee structures is essential, as it allows investors to make informed decisions and compare the value offered by different portfolio managers.

Investors have two main options when it comes to managing their money: either hiring a discretionary manager or joining a collective investment scheme that deals in foreign exchange and/or offshore assets. In such a scenario, the fee levied by the portfolio or collective investment plan management will be proportional to the portfolio's value.

To keep their investment under constant supervision, investors pay a management fee to the asset manager once a year. Funds and asset managers charge different fees for managing their assets. Further, it is not uncommon for a single fund to have many charge classes. Clients that access the

fund through an investment platform, retail clients, and institutional clients are some examples of the target clients that inform the creation of the various fee classes. A performance fee could be imposed by some funds.

Fund administrators, custodians, and auditors are paid a portion of the total administrative charge.

Trading securities results in transaction expenses. All fees imposed by the manager are subject to value-added tax (VAT)

Fees applicable to an investment adviser

Investment advisers typically charge fees based on the services they provide, which can include financial planning, investment management, and ongoing portfolio monitoring. These fees can be structured in various ways, such as a flat fee, hourly rate, or a percentage of assets under management. It is essential for clients to understand the fee structure and what services are included, as some advisers may offer comprehensive financial planning services that justify higher fees. Additionally, clients should inquire about any potential conflicts of interest, such as commissions from product sales, which could influence the adviser's recommendations. Being aware of these factors can help investors make informed decisions about their financial advisory services.

Any time a client uses the services of a financial advisor, they will incur fees. The first consultation could cost you, and it could be in the form of a percentage of your investment. Additionally, for continuing services, clients will be charged an ongoing advisory fee.

Investment Platform Fees

Investment platforms may also charge additional fees, such as transaction fees for buying or selling funds, which can vary based on the platform's pricing model. Some platforms offer a flat fee for unlimited trading, while others may charge per transaction, which can add up for active traders. Furthermore, investors should be aware of any exit fees or transfer fees that may apply if they decide to move their investments to another platform. Understanding these potential costs is

crucial for investors to effectively manage their overall investment expenses and maximize their returns.

Investing through a platform which provides administrative financial services is frequently the most convenient and cost-effective way to obtain unit trust investments. An investor can easily move between several providers' funds by utilizing an investment platform. When investors want to invest via an investment platform instead of investing directly, these providers sometimes provide cheaper fee classes. There will be an administrative fee associated with the platform's services for investors.

2 TAX ON FOREX INVESTMENTS

When it comes to tax obligations, traders should also be aware of the distinction between capital gains tax and income tax. In South Africa, if forex trading is classified as a capital investment, profits may be subject to capital gains tax, which is generally lower than income tax rates. However, if trading is deemed to be a regular business activity, the profits will be taxed as ordinary income. This classification can significantly affect the overall tax liability, making it crucial for traders to maintain accurate records of their trading activities and consult with a tax advisor to determine the most advantageous tax treatment for their specific situation.

In South Africa, the tax implications on forex trading can be significant. Forex trading profits are generally considered taxable income and must be reported to the South African Revenue Service (SARS). Traders may be subject to income tax on their profits, and the applicable tax rate will depend on their overall income bracket. Additionally, if forex trading is conducted as a business, traders may be able to deduct certain expenses related to their trading activities, such as broker fees and other costs mentioned in your article. It is advisable for traders to consult with a tax professional to ensure compliance with local tax laws and to optimize their tax situation.

In addition to understanding the various fees and tax implications, traders should also consider the impact of market volatility on their trading costs. Fluctuations in currency prices can lead to wider bid-ask spreads, which effectively increase the cost of entering and exiting trades. Moreover, during periods of high volatility, brokers may adjust their commission structures or impose additional fees to account for the increased risk. Therefore, it is essential for traders to stay informed about market conditions and how they can influence trading costs, as this knowledge can

help them make more strategic decisions and better manage their overall expenses in the forex market.

The module on forex trading has provided a comprehensive overview of the various fees, charges, and tax implications associated with trading foreign exchange. Key takeaways include the importance of being aware of the different types of fees, such as commissions charged by brokers, portfolio management fees, and investment platform fees, which can significantly impact overall returns.

Investors must carefully evaluate the fee structures of their chosen brokers and investment platforms to ensure they are making informed decisions that align with their trading strategies. Additionally, understanding the tax obligations related to forex trading is crucial, as the classification of trading activities can affect tax liabilities.

By maintaining accurate records and consulting with financial and tax professionals, traders can optimize their investment strategies and ensure compliance with local regulations. Overall, this module emphasizes the necessity of thorough research and strategic planning in forex trading to maximize profits and minimize costs.

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