

**WORLD 1 / CHAPTER 1**

**THE FX SPOT MARKET**

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## DER KASSADEVISENMARKT

A spot FX transaction is the purchase or sale of one currency for another, with delivery usually two days after the dealing date.

### 1. Market Conventions

The exchange rate at which the spot transaction is done is called the "spot rate".

#### Value date of spot transactions

The delivery day of a spot transaction is called value date. Business days do not include Saturdays, Sundays or bank holidays in either of the countries of the two currencies involved. If the "normal" value date (two days after the dealing date) falls on a public holiday in one of the centres of the currencies involved, the next working day is taken as the value date for the transaction.

#### Example

A USD/JPY spot transaction - with dealing date on Wednesday the 4th of January - would normally have value date on Friday, the 6<sup>th</sup> of January. If however the 6<sup>th</sup> of January is a public holiday in Japan or in the US, the value date will be deferred to Monday the 9<sup>th</sup> of January.

There are however some exceptions to these general rules:


- USD-CAD-transactions are often dealt on a so called "**funds**"-basis. This means that delivery will be done 1 working day after the dealing date.
- FX markets in the Middle East are closed on Fridays but open on Saturdays. A USD-SAR transaction could therefore have a split settlement date, with the USD delivered on Friday and the SAR delivered on Saturday.
- The value date of cross transactions (FX spot deals not involving the USD) might be deferred due to US public holidays.

### Swift Codes

Each currency can be identified by a three letter code. The first two letters refer to the name of the country. The third letter refers to the name of the currency. These codes are used by the Swift message system and have become international accepted standards.

The major currencies and their swift codes are listed in the appendix.

For some currencies the terms used in the market do not correspond to these swift codes

 **Example**

Cable = GBP/USD  
Yen = JPY  
SFR = CHF

### Base currency and variable currency

Spot rates are quoted as one unit of the quoted (base) currency against a number of units of the variable currency

X units of variable currency = 1 unit of base currency

When spot rates are quoted, the first currency always represents the base currency (quoted currency) and the second currency is the variable currency.

**Example**

	<i>Quoted Currency / Base Currency</i>	<i>Variable Currency /</i>
EUR/USD	Euro	US-Dollar
USD/CZK	US-Dollar	Czech Crown

**Example**

If the spot rate quoted for EUR/USD is 1.1850, this means that one Euro is worth 1.0150 USD.

**Bid and offer rates**

Spot rates are usually quoted in two rates, the bid rate and the offer rate.

EUR/USD 1.0152/1.1860 or

EUR/USD 1.0152-60 or

The **bid rate** is the rate at which the bank quoting the price (the market maker) is ready to buy the base currency from the market user (the counterpart asking for a price).

The **offer rate** is the price at which the market maker will sell the base currency to the market user.

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**Market Maker**

Bid Rate:	buys base currency	Offer rate:	sells base currency
	Sells variable currency		Buys variable currency

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**Market User**

Bid rate:	sells base currency	Offer rate:	buys base currency
	Buys variable currency		Sells variable currency

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The market user is the counterpart asking for prices. The market user may be a corporation, an institutional investor, a bank or the national bank.

If a dealer receives a call from another bank, in order to make a quote, he acts as the market maker. If the same dealer is calling another bank in order to ask for prices he acts as the market user.

In order not to be confused by the different dimensions (market maker/market user, bid/offer, base currency/variable currency) we suggest the following procedure:

- I. Adjust the question to be answered for the quoted currency  
This means e.g. for a EUR/USD quotation and a question where USD are bought (or sold), the question should be adjusted to Euro to be sold (or bought)
- II. Adjust the question to be answered to market user/market-maker.  
Market-maker (quoting bank) **buys** at **bid rate** and **sells** at **offer rate**  
Market-user (bank asking for a quote) **buys** at **offer rate** and **sells** at **bid rate**

 **Example**

A company wants to buy USD 10 Mio against EUR. A bank quotes 1.1850/60 as the EUR/USD rate.

- I. The quoted currency is the EUR. The company wants to buy USD, meaning it sells EUR.
- II. The company sells EUR and receives the quotes 1.1850/60. As market user the Euros are sold at the bid rate (1.1850).

This means that the company buys USD 10 Mio at the rate of 1.1850. It receives USD 10 Mio and pays

$$9.216.589,9 \text{ EUR} \left( \frac{10.000.000}{1,0850} \right)$$

## Spread

The spread is the difference between the bid and offer rates.

<i>Quoted Currencies</i>		
	Buying Rate (Bid)	Selling Rate (Offer)
USD/CHF	1,4720	1,4730
EUR/USD	1,0125	1,0130
USD/CZK	30,210	30,220
USD/NOK	7,4500	7,4800
CHF/JPY	86,760	86,800
USD/JPY	105,80	105,90
USD/SEK	6,7270	6,7300
GBP/USD	1,5585	1,5595
GBP/JPY	195,70	195,90

The rates shown are the bid and offer rates for interbank spot deals. For customers, spreads are normally a little wider.

If USD/CHF is quoted 1.4720/30 , the bid rate is the buying price quoted for the USD (or selling price for the CHF). The offer rate is the selling price for the USD (or the buying price for the CHF).

### Long-, short-, square-position

Banks / dealers of foreign currency, have a long, short or square position in the different currencies.

- A **long-position** in a currency means that the dealer has bought more of the currency than he has sold. If this position is taken purposely the dealer expects the currency to rise.
- Having sold more than bought the dealer speaks of a **short position** in a currency. The expectation will normally be that of a declining rate.
- A **square-** or a **flat position** in one currency means that the dealer has bought and sold the same amount of currency and has no risk if the rates change.

### Direct / indirect quote

In the international financial markets some currencies are normally used as quoted currencies. In most of the quotes the USD is the quoted currency.

In the home market it is sometimes more convenient to reverse the quoting conventions. The method to quote Czech Crowns against Swiss Francs, may in this case be in Prague different to Zurich.

- A direct quote is a quote where the home currency is the base currency and the foreign currency is the quoted currency. In most of the cases the quote is done for 100 units of the variable currency. For example, in the USA the rate for Swiss Francs against USD could be quoted at 0.8756, or 87.56 (i.e. USD 87.56 for 100 CHF)''
- In the indirect quote the home currency is the quoted currency and the foreign currency is the variable currency.

The indirect quote is the reciprocal value (1 divided by) of the direct quote. In order to get an indirect quote the following rules have to be observed:

- The bid of the indirect quote is the reciprocal value of the offer rate of the direct quote.
- The offer of the indirect quote is the reciprocal value of the bid rate of the direct quote.

Formula:

<i>Rates 8indirect quote9</i>	
Bid Rate	Offer Rate
$\frac{1}{\text{Offer}_{\text{direct}}}$	$\frac{1}{\text{Bid}_{\text{direct}}}$

**Example**

In New York the direct quote for USD will be:  
 USD/GBP      0.6169 - 0.6173

The corresponding indirect (London) quote may be computed:  
 GBP/USD

GBP, bid rate:       $\frac{1}{0.6173} = 1.6200$

GBP/USD, offer rate:       $\frac{1}{0.6169} = 1.6210$

Or per GBP 100:      162.00 – 162.10  
    162.00 - 10

**Pips and the "big figure"**

The last two digits of the spot rate are the so called pips or basis points. The rest of the spot quotation is called the "big figure".

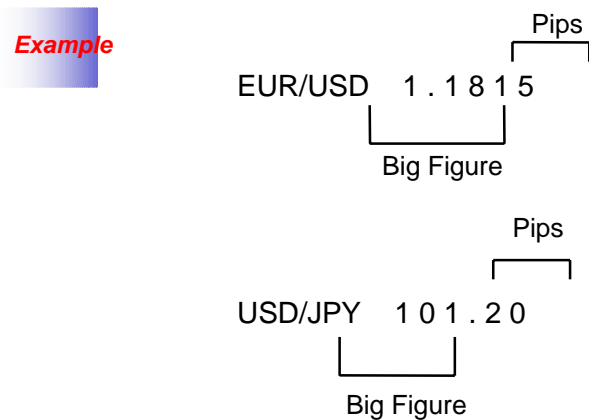
In general the pip is one hundredth of one hundredth of a currency

**Example**

USD 0.0001  
 EUR 0.0001  
 CHF 0.0001

However, some exceptions can be observed in the markets. For a USD/YEN quotation one pip is one hundredth of a YEN (JPY 0.01).

Spot rates are usually quoted with 5 digits. The first three digits are the big figure.



In day to day business, spot dealers assume that, every counterpart knows the big figure for the given quotation. Due to this spot rates are often quoted only with their pips. As this may be rather dangerous (especially in very volatile markets), the code of conduct recommends to indicate the big figure for every deal.

## 2. Cross rates

In the professional spot markets most of the deals are done with the USD as the quoted currency. Since some years however, cross deals (deals where the USD does not appear at all) have increased in importance.

Every cross rate can be computed by using the corresponding USD quotes.

**Example**

Following rates are quoted in the market:

USD/CHF 1.4980-1.4985

USD/NOK 6.3272-6.3292

Using the quote of CHF and NOK against the USD, the NOK/CHF cross rate can be calculated.

The first step consists in fixing the quoted currency for the desired cross rate. This may be any of the two currencies.

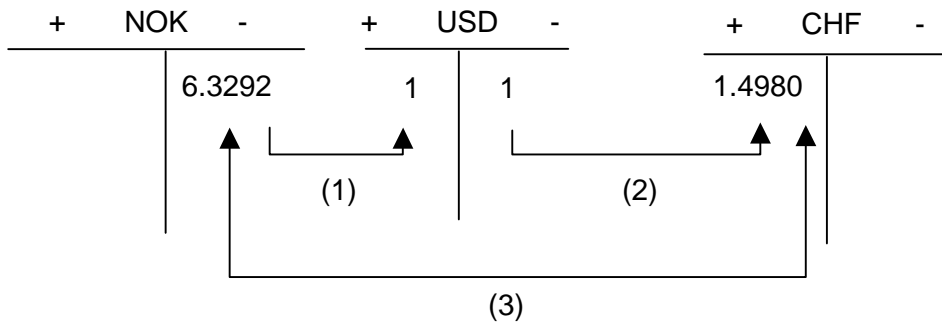
In our example we use the Norwegian Crown as the quoted currency for the NOK/CHF cross rate.

### Bid rate

In order to compute the bid rate (at which we sell NOK against CHF) we have to do the following transactions:

- We buy USD against NOK (6.3292)
- We sell USD against CHF (1.4980)

- By dividing the CHF amount with the NOK amount we know the rate at which we can sell the NOK



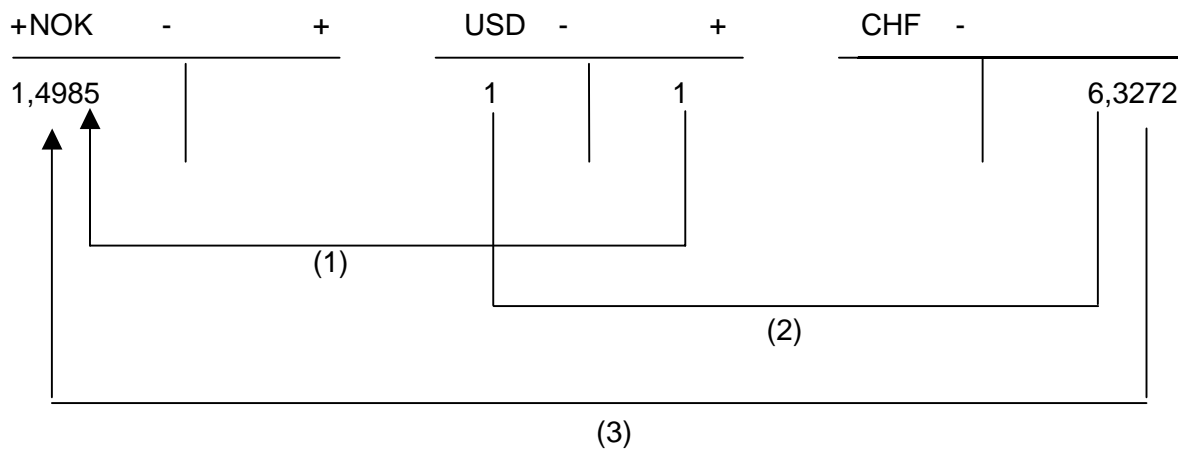
$$\frac{1,4980}{6,3292} = 0,23662$$

The bid rate of NOK 1 against CHF 0.23668.

**Offer rate**

In order to compute the offer rate (at which we buy NOK against CHF) we have to do the following transactions:

- We sell USD against NOK (6.3272)
- We buy USD against CHF (1.4985)
- By dividing the CHF amount with the NOK amount we know the rate at which we can buy NOK



The offer rate for NOK 1 against CHF is 0.23683

$$\left( \frac{1,4985}{6,3272} \right)$$