

# Foreign exchange market and the us dollar

[Finance](#), [Market](#)



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### I. Introduction

For human being, trade has been a way of survival. People of the ancient past has been trading to fulfil their daily needs and wants. In those times however, people would have to barter to trade their belongings to what they need or want. Today, there are various means of trading, cash trading (using money) or credit trading (using various forms of letters of understanding). Further, the development of human's needs and wants has brought human beings into the globalization age, where trade is no longer restricted by national or regional boundaries.

In the age of international trading, another issue appears. International finance has been a very popular economic science nowadays. This is due to the fact that foreign trade has been growing tremendously in significance. People has been searching means to create comfortable trade between people of different nationalities. This is the simple origin of the foreign exchange (forex) market. Today, people trade in foreign markets just as common as they would trade on traditional markets. In the light of this development, I believe that the discussion on forex and its history is an interesting subject. Furthermore, in this paper, we are discussing on the issue of weakening US Dollar against several other powerful currencies.

### II. History of Foreign Exchange

#### II. 1. Definition and Size of Market

In definition, the forex market is a place where people can trade one currency into another. The market is in fact the largest market compane to

any other kind of markets around the globe today. Compare to the trading volume of the US treasury bond, which is only \$ 300 billion a day, the forex out-trade the US treasury bond trading by having a daily circulation of \$ 1, 8 trillion.

## II. 2. Preceding International Agreements

### II. 2. 1. Gold Exchange Standard

The forex market was originated in 1971 when people begin to recognize the benefits of floating exchange. Prior to the date there were several other rules that were set to manage international trade. The first international rule for managing international trade was actually the gold exchange standard. The standard was placed in attempt to prevent kings and rulers from making more money than they should be and create uncontrollable inflation. The first rule was the gold exchange standard. Under the gold exchange standard, each currency must be backed by gold (Millman, 2005).

Like we would most likely presume, the first rule would have considerable problems within it. Under the gold exchange standard there is a dangerous opportunity for an economy to import more goods than it can manage, which lead to depleted gold reserves. Applying the gold exchange standard, the country would have to reduce its money supply and as a result, the economic activity within the country would be forced to slow down and a recession would be created (Millman, 2005).

As a balancing action however, the recession would then lead to price-drops all over the nation and the country would suddenly be more attractive as destination of foreign investment. This will lead gold back into the country

and the prices of goods would rise back into their original state. The system would seem to be flawless, but as the First World War struck the globe, people realized that they cannot depend on gold to manage international economy. This is true because the flow of gold is dangerously easy to disrupt.

## II. 2. 2. Bretton Woods Agreement

Afterwards, the controlling set of rules is called the Bretton Woods Agreement. Under the Bretton Woods agreement, international trade was focused on a single purpose, which is to promote stability in international trade by preventing speculation in the currency markets and preventing money from uncontrollably circulated around the country. In order to meet this purposes, the agreement fixed all national currencies against dollar under the rate of \$35 perounce of gold. In light fo this agreement, all nations agreed to maintain the value of their currencies againts the US dollar. Countries were not allowed to improve their trade positions by devaluating their currency by more then 10%. Again, the international understanding was disrupted by war. The Second World War devastate economis all over the world, and afterwards, the nations are urging to rebuild their countries. This lead to rapid movement of capital whcih is not supported by the Bretton Woods Agreement (Millman, 2005).

## II. 3 Forex

In 1971, the forex market with the floating exchange system come about and replace the rules of Bretton Woods. Shortly after the introduction of the forex market, countrues change their currency systems into the free floating

arrangement, where prices are mainly controlled by the forces of supply and demand.

### II. 3. 1. Effects of Forex Introduction

The introduction of forex brought significant changes in international economy. Since the introduction of the forex market, new financial tools and instruments were created. Examples of the most utilized forex instruments are forward contracts, futures contracts, options, etc. The good-trading markets also experience considerable changes due to the forex. They became more open and deregulated in nature. Further, a new group of people came to power along with the introduction of forex. These people were the speculators and money traders (Millman, 2005).

### II. 3. 2. Technological Advancement and the Forex

As mentioned in the introduction chapter, in the age of globalization, people trade in forex market just as common as they would trade in traditional markets. The powerful catalyst of the phenomenon is technology and innovation. With the presence of the internet and on-line market trading, movement of money across border became very easily managed. Small traders, large traders and financial institutions are all using technological advancement to tune-into the market in daily manner. Thus, millions of dollars worth of foreign exchange transaction began to take place in matters of hours and even minutes. Electronic brokers, among other things that grows from the forex, has been significant catalysts to the growth and development of the forex.

### II. 3. 3. From Buying to Speculating

Another significant change created by the forex is the fact that most people has shifted their purpose when they are engaging in the forex market. If the original purpose of trading the forex is to obtain the necessary currency to perform cross-border transactions, today, the most popular purpose of entering the forex market is to speculate. Speculation is the activity to buy and sell foreign currencies in order to gain profit from the money transaction. If in the earlier days of forex, speculators are only minor traders with minor proportion of the circulation, today, the speculators could well be affecting the course of international businesses.

There are significant concerns regarding the shifted purpose of the activity. First, as suggested by the Bretton Woods Agreement, the activity of making money out of money is dangerous for international business. The concern was based on the fact that making profit out of money trading is like creating money from no actual trade of products or services. In other words, some considers that speculators are stealing profit from the system which is only intended to support international trade of real products and services. Furthermore, there are cases where speculators could be so powerful that their actions are suspected to be the catalyst of economic recession for an entire region of developing countries (the Asian economic recession). Today however, this view is largely abandoned by most financial observers. With the presence of several new rules in the forex, speculators are considered a natural part of the system.

### III. US Dollar on Forex

#### III. 1. Dollars Against the Euro, Pound Sterling and Yen in 2006

In the forex market, one can easily discover the value of a single currency compare to others. Generally, the US dollar has been considered the most influential currency of the world. However, recent developments indicated that the currency also has its ups and downs. During 2006 of example, reports indicated that the dollar has performed rather poorly against most of the European currencies. According to Market Watch, as a summary of 2006, dollar has dropped 11. 5% versus the Euro. Analyst indicated that among other causes, this is caused by the unlikely prospect of Federal Reserve cutting interest rates to enhance growth considering the the interest rates in Europe continued to be higher. Against the Pound Sterling, the US dollar has also weakened in 2006 by 13. 6%. Versus the Swiss Franc, the 2006 history indicated that the currency weakened 7. 3%. Some of the reason of Euro's triumph over the US dollar in 2006 is the enhancement of the Euro due to the stronger growth of money supply in the Eurozone (Weakening, 2006).

Despite the weak performance against European currencies, the US dollar display increasing value compare to Yen. Yen is considered the weakest among several international currencies in the course of 2006. The US dollar was rising about 1. 3% against Yen for 2006. The Yen was weakened 12. 6% against the Euro and 14. 9% against the Pound Sterling. Many considered that this is caused by the end of the zero interest policy applied by Japanese policymakers for six of the last years. The future of Yen is uncertain, said several analysts of Marketwatch. This is caused by the BoJ maintaining their steady position in the face of Yen weakening again. Another cause of the Yen's poor performance during 2006 is the slowing down of Japanese

purchasing index in December, which is considered the lowest in 21 months (Zhou, 2005).

There are several issues that were involved in the weakening of US dollar against other amjor currencies. One is the issue of US dollar sell-off due to increasing interest in becoming overseas investors. Another cause is the presence of large imbalance of trade with China. The currency also burdened with local issues like the slowing down of domestic housing market. Other concerns that are suspected to weakened the value of dollar are actually long-time concerns like inflation, lower home prices, adverse tax changes and high ebergry costs. More than others however, the main cause of weakening US dollar against European currencies is because economic growth in some European countries enhanced notably during 2006 (Zhou, 2006).

The weakening dollar position against European currencies has actually been rather a surprise for several observers because the review of forex taken in November 2005 stated that the dollar reached a high position with respect to Euro and yen. At the moment the position was predicted to last for some time because overseas investors favored US businesses. The prediction was proven to be false. Since then, the value of dollar has been decreasing due to several factors, which are: global imbalances concerns revealed by the group of seven, US trade deficits. The positive aspect of this decline is that it will cause foreign investors to be more attracted to invest globally. Furthermore, a weaker dollar will result foreign currency returns to worth more than it usually is ('Dollar weakens', 2006).

### III. 2. Prospects of Dollar on 2007

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Analysts stated that there is considerable room for more decrease in 2007 for the US dollar. Another analysis indicated that the trend will still continue throughout 2007, because there is considerable expectations that the European Central Bank will continually enhance interest rates. However, analysts also stated that the enhancement of US economy will provide some room for dollar enhancements before it falls again. Analysts also argued that the US economy has more strength than people generally took credit for. Low unemployment and robust economic growth are some indicators that supports the positive sentiments toward the US dollar in the future (Zhou, 2006).

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