

History of Foreign Exchange

The foreign exchange market (fx or forex) as we know it today originated in 1973. However, money has been around in one form or another since the time of Pharaohs. The Babylonians are credited with the first use of paper bills and receipts, but Middle Eastern moneychangers were the first currency traders who exchanged coins from one culture to another. During the middle ages, the need for another form of currency besides coins emerged as the method of choice. These paper bills represented transferable third-party payments of funds, making foreign currency exchange trading much easier for merchants and traders and causing these regional economies to flourish.

From the infantile stages of forex during the Middle Ages to WWI, the forex markets were relatively stable and without much speculative activity. After WWI, the forex markets became very volatile and speculative activity increased tenfold. Speculation in the forex market was not looked on as favorable by most institutions and the public in general. The Great Depression and the removal of the gold standard in 1931 created a serious lull in forex market activity. From 1931 until 1973, the forex market went through a series of changes. These changes greatly affected the global economies at the time and speculation in the forex markets during these times was little, if any.

The Bretton Woods Accord



The first major transformation, the Bretton Woods Accord, occurred toward the end of World War II. The United States, Great Britain and France met at the United Nations Monetary and Financial Conference in Bretton Woods, N.H. to design a new global economic order. The location was chosen because, at the time, the U.S. was the only country unscathed by war. Most of the major European countries were in shambles. Up until WWII, Great Britain's currency, the Great British Pound, was the major currency by which most currencies were compared. This changed when the Nazi campaign against Britain included a major counterfeiting effort against its currency. In fact, WWII vaulted the U.S. dollar from a failed currency after the stock market crash of 1929 to benchmark currency by which most other international currencies were compared. The Bretton Woods Accord was established to create a stable environment by which global economies could restore themselves. The Bretton Woods Accord established the pegging of currencies and the International Monetary Fund (IMF) in hope of stabilizing the global economic situation.

Now, major currencies were pegged to the U.S. dollar. These currencies were allowed to fluctuate by one percent on either side of the set standard. When a currency's exchange rate would approach the limit on either side of this standard the respective central bank would intervene to bring the exchange rate back into the accepted range. At the same time, the US dollar was pegged to gold at a price of \$35 per ounce further bringing stability to other currencies and world forex situation.

The Bretton Woods Accord lasted until 1971. Ultimately, it failed, but did accomplish what its charter set out to do, which was to re-establish economic stability in Europe and Japan.

The Beginning of the free-floating system

After the Bretton Woods Accord came the Smithsonian Agreement in December of 1971. This agreement was similar to the Bretton Woods Accord, but allowed for a greater fluctuation band for the currencies. In 1972, the European community tried to move away from its dependency on the dollar. The European Joint Float was established by West Germany, France, Italy, the Netherlands, Belgium and Luxemburg. The agreement was similar to the Bretton Woods Accord, but allowed a greater range of fluctuation in the currency values.

Both agreements made mistakes similar to the Bretton Woods Accord and in 1973 collapsed. The collapse of the Smithsonian agreement and the European Joint Float in 1973 signified the official switch to the free-floating system. This occurred by default as there were no new agreements to take their place. Governments were now free to peg their currencies, semi-peg or allow them to freely float. In 1978, the free-floating system was officially mandated.

In a final effort to gain independence from the dollar, Europe created the European Monetary System in July of 1978. Like all of the previous agreements, it failed in 1993.

The Explosion of the Euromarkets

A major catalyst to the acceleration of Forex trading was the rapid development of the Eurodollar market; where US dollars are deposited in banks outside the US. Similarly, Euromarkets are those where assets are deposited outside the currency of origin. The Eurodollar market first came into being in the 1950s when Russia's oil revenue-- all in dollars -- was deposited outside the US in fear of being frozen by US regulators. That gave rise to a vast offshore pool of dollars outside the control of US authorities.

The US government imposed laws to restrict dollar lending to foreigners. Euromarkets were particularly attractive because they had far less regulations and offered higher yields. From the late 1980s onwards, US companies began to borrow offshore, finding Euromarkets a beneficial center for holding excess liquidity, providing short-term loans and financing imports and exports.

London was, and remains the principal offshore market. In the 1980s, it became the key center in the Eurodollar market when British banks began lending dollars as an alternative to pounds in order to maintain their leading position in global finance. London's convenient geographical location (operating during Asian and American markets) is also instrumental in preserving its dominance in the Euromarkets.

The major currencies today move independently from other currencies. The currencies are traded by anyone who wishes. This has caused a recent influx of speculation by banks, hedge funds, brokerage houses and individuals. Central banks intervene on occasion to move or attempt to move currencies to their desired levels. The underlying factor that drives today's forex markets, however, is supply and demand. The free-floating system is ideal for today's forex markets. It will be interesting to see if in the future our planet endures another war similar to those of the early 20th century. If so, how will the forex markets be affected? Will the dollar be the safe haven it has been for so many years? Only time will tell.