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Currency classifications

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INTRODUCTION

The foreign exchange market has its own jargon as does the currency option market. It is quite likely that you will have heard references to the 'five majors', 'minor currencies', 'basket currencies', 'emerging markets' or maybe even 'crosses'. In this section we will explain the various different classifications. One method of classifying currencies relates to the ease of conversion between them and what restrictions, if any, government or otherwise, might apply to their spot and forward markets. Generally there are three important subdivisions.

BROAD CLASSIFICATION OF CURRENCIES

Major currencies

Freely available in the spot and forward markets.

Minor currencies

Freely available, although the spot market may from time to time lack liquidity. Restrictions can be imposed on the forward market in terms of maturity, i.e. not more than six months.

Emerging market currencies

Spot rates are available, but may be restricted with regard to transaction amount or government intervention. The forward market could be lacking, intermittent, or very expensive. Often currencies transact on a non-deliverable basis, known in the markets as NDFs. For more information on NDFs see Chapter 9, Emerging Market Foreign Exchange by Andrew Medhurst from HSBC.

INDICATIONS OF CURRENCY CLASSIFICATIONS

Major currencies

US dollar, Euro, Swiss franc, Japanese yen, UK sterling.

Minor currencies

Norwegian krone, Singapore dollar, Danish krone, Swedish krona, Hong Kong dollar.

Emerging market currencies

Indonesian rupiah, Thai baht, Malaysian ringgit, Vietnam dong, Chinese renminbi, Philippines peso, South African rand.

MAJOR CURRENCIES

The top five major currencies in foreign exchange trading are the US dollar, Euro, Japanese yen, Swiss franc, and British sterling. They should not be confused with similar abbreviations such as that for the G5 or even the G7 – the Group of seven nations, which comprise USA, France, Great Britain, Germany, Japan, Canada, and Italy. Each of the top five major currencies exhibits complete currency convertibility in large amounts, with an active long-dated forward market, sometimes over five years forward.

MINOR CURRENCIES

These are the currencies where there is complete convertibility but where there may be difficulties executing the full amount in a large transaction, for example in excess of USD 50 million equivalent. Alternatively, the forward market may only go out for perhaps 12 months or a year, or it may be relatively expensive.

EMERGING MARKET CURRENCIES

Over the last few years the term 'Exotic currency' has been dropped and those currencies are now included within the term 'emerging market', which can cover many things. Generally these are the currencies of the newly deregulated Eastern bloc countries, such as Poland, the Czech Republic, Slovakia and Hungary, Russia, Romania, the Baltic states of Lithuania, Latvia and Estonia, together with all of the South American currencies and all of the African currencies. If you then include the old exotic currencies which were typically Far Eastern (Thai baht, Singapore dollar, etc.) you have a currency block which covers a major part of the globe.

CROSS CURRENCIES

The definition of a cross currency is where a foreign exchange market price is made in two currencies, not involving the US dollar. Historically, the US dollar has been used as the medium of exchange, between currencies, but about twenty years ago the FX market started to expand the use of direct 'cross' dealing.

Consider a company based in the UK, selling goods to Switzerland and receiving payment in Swiss francs. Before 'crosses' evolved to their current level, it would have been necessary for the company to sell the Swiss francs for dollars and then sell the dollars for sterling. This would have involved them not only paying away the 'bid–offer spread' but also the possibility of running a potential dollar exposure if the two deals were not transacted simultaneously, not to mention further complications with forwards and options, etc. The major traded crosses are:

- EUR/JPY
- EUR/GBP
- EUR/CHF

Notice that the EUR is an integral part of cross-trading, although other crosses exist such as:

- GBP/CHF
- GBP/JPY

As the growth of cross markets continued, more and more banks were faced with customers requiring both cross currency rates and cross derivatives. By the early 1990s the market had grown enormously, leading to a common trading practice where some cross rates are used to quote other less well traded crosses. For further details on how to calculate cross currency rates see the section in Chapter 7, The Mechanics of Spot Foreign Exchange.

Cross currency arbitrage

This is one of the advantages of cross currency trading. It applies mainly to banks and brokers who are set up for the purpose. In simple terms, if the currency that is being traded is EUR/JPY, and a counterparty sells the bank EUR against yen, the bank has the option of either:

1. selling the EUR on to another counterparty;
2. trading out through the dollar, by selling EUR, buying dollars, then, selling dollars and buying yen.

If you can transact at a better rate through using the direct market (through the US dollar), then cross currency arbitrage is possible, sometimes known as triangular arbitrage.