Foreign Exchange markets and currency speculation: Historical perspectives

By Olivier Accominotti, Financial Market History-Reflections on the past for investors today, The CFA Institute Research Foundation, 2016.

The forex market is considered the largest financial market in the world. Between 2001 and 2016, the global turnover on currency markets increased from $ 1.2 to $ 5.1 trillion per day.

Until the end of the 19th century, the forex market primarily consisted of bills. By this time, bills had become negotiable and discountable instruments, enhancing their liquidity. The Dutch Guilder was the leading international currency in the world, till it was superseded by the pound sterling.

The new trans-Atlantic cable completed in 1866 facilitated foreign exchange dealings via telegraphic transfers. The importance of bills of exchange progressively declined. However, it was only after World War I that transfers via cables and telephone became widespread and outstripped transfers of bills via mail. The new cable lines set up during the war and the improvement of telegraphy contributed to this development. Forex transactions began to be undertaken on the phone between the main banks and through brokers.

In the post-World War-I period, a large forward exchange market developed for the first time in London. In parallel with the development of the forward markets, a market for currency options developed in New York in the immediate post World War I years. However, dealings in options remained subdued, compared to forwards. Currency options took off on a large scale in the 1970s.

Macroeconomists have viewed currency investing with scepticism for two reasons:

- Uncovered interest parity eliminates the possibility of earning higher returns on a currency.
- Macroeconomic models have been quite poor at predicting changes in exchange rates.

Some currency speculation strategies seem to have done well, based on empirical evidence:

- **Carry trade** consists of borrowing in low interest rate currencies and investing in high interest rate ones.
- **Momentum** consists of borrowing in currencies with low recent returns and investing in currencies with high recent returns. Momentum

strategies seem to do well when implemented over a basket of developed and emerging market currencies over a long time horizon.

The carry trade yielded high risk adjusted returns during the floating exchange rate periods of 1920-1927 and 1985 -2012 but did not do so well during the managed float period of the 1930s.The performance of the momentum strategy was also much stronger in the 1902s than in any other period including the modern period. Both strategies incurred huge losses in certain months in both the inter war and the modern periods.

Another strategy that is common is borrowing in overvalued currencies and investing in undervalued currencies based on an assessment of the real exchange rate.

Conclusion

Foreign exchange speculation is not a modern-day phenomenon. Returns to simple speculation strategies such as carry trade and momentum are positive and high in the long run. But they also vary over time and large losses can occur at certain times. Making money from currency speculation is challenging and requires taking substantial risk.