Chapter : 6 Speculations in Foreign Exchange Markets

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Introduction:

Financial speculation, involves the buying, holding, selling, and short-selling of stocks, bonds, commodities, currencies, collectibles, real estate, derivatives, or any valuable financial instrument to profit from fluctuations in its price as opposed to buying it for use or for income via methods such as dividends or interest. Speculation or agiotage represents one of four market roles in Western financial markets, distinct from hedging, long- or short-term investing, and arbitrage.

Controversy about currency speculators and their effect on currency devaluations and national economies recurs regularly. Nevertheless, many economists (e.g. Milton Friedman) have argued that speculators perform the important function of providing a market for hedgers and transferring risk from those people who don't wish to bear it, to those who do. Other economists, may consider this argument to be based more on politics and a free market philosophy than on economics.

Large hedge funds and other well capitalized "position traders" are the main professional speculators.

Currency speculation is considered a highly suspect activity in many countries. While investment in traditional financial instruments like bonds or stocks often is considered to contribute positively to economic growth by providing capital, currency speculation does not; according to this view, it is simply gambling that often interferes with economic policy. For example, in 1992, currency speculation forced the Central Bank of Sweden to raise interest rates for a few days to 150% per annum, and later to devalue the krona. Former Malaysian Prime Minister Mahathir Mohamad is one well known proponent of this view. He blamed the devaluation of the Malaysian ringgit in 1997 on George Soros and other speculators.
Gregory Millman reports on an opposing view, comparing speculators to "vigilantes" who simply help "enforce" international agreements and anticipate the effects of basic economic "laws" in order to profit.

In this view, countries may develop unsustainable financial bubbles or otherwise mishandle their national economies, and forex speculators made the inevitable collapse happen sooner. A relatively quick collapse might even be preferable to continued economic mishandling. Mahathir Mohamad and other critics of speculation are viewed as trying to deflect the blame from themselves for having caused the unsustainable economic conditions. Given that Malaysia recovered quickly after imposing currency controls directly against IMF advice, this view is open to doubt.

6.1 Speculation

6.1.1 Speculation areas

Convention, and especially satire, sometimes portray speculators comically as speculating in pork bellies (in which a real market and real speculators exist) and often "losing their shirts" or making a fortune on small market changes. Speculation exists in many such commodities, but, if measured by value, the most important markets deal in futures contracts and other derivatives involving leverage that can transform a small market movement into a huge gain or loss.

6.1.2 Type of speculators

Most non-professional traders lose money on speculation, while those who do make money tend to become professionals. Occasionally some dramatic event will occur, such as the effort of the Hunt brothers to corner the silver market or the currency speculations of George Soros or the speculative trading of Nick Leeson, which caused the collapse of Barings Bank.

By some definitions, most long-term investors, even those who buy and hold for decades, may be classified as speculators, excepting only the rare few who are not primarily
motivated by eventually selling at a good profit. Some dedicated speculators are distinguished by shorter holding times, the use of leverage, by being willing to take short positions as well as long positions (in markets where the distinction can be reasonably made). A degree of speculation exists in a wide range of financial decisions, from the purchase of a house to a bet on a horse; this is what modern market economists call "ubiquitous speculation."

In Security Analysis, Benjamin Graham gave a definition of speculation in relation to investment: "An investment operation is one which, upon thorough analysis, promises safety of principal and a satisfactory return. Operations not meeting these requirements are speculative."

6.1.3 The economic benefits of speculation

The well known speculator Victor Niederhoffer, in "The Speculator as Hero" describes the benefits of speculation:

Let's consider some of the principles that explain the causes of shortages and surpluses and the role of speculators. When a harvest is too small to satisfy consumption at its normal rate, speculators come in, hoping to profit from the scarcity by buying. Their purchases raise the price, thereby checking consumption so that the smaller supply will last longer. Producers encouraged by the high price further lessen the shortage by growing or importing to reduce the shortage. On the other side, when the price is higher than the speculators think the facts warrant, they sell. This reduces prices, encouraging consumption and exports and helping to reduce the surplus.

Another service provided by speculators to a market is that by risking their own capital in the hope of profit, they add liquidity to the market and make it easier for others to offset risk, including those who may be classified as hedgers and arbitrageurs.

If a certain market - for example, pork bellies - had no speculators, then only producers (hog farmers) and consumers (butchers, etc.) would participate in that market. With fewer players in the market, there would be a larger spread between the current bid and ask price of pork bellies. Any new entrant in the market who wants to either buy or sell pork bellies would be forced to accept an illiquid market and market prices that have a large
bid-ask spread or might even find it difficult to find a co-party to buy or sell to. A speculator (e.g. a pork dealer) may exploit the difference in the spread and, in competition with other speculators, reduce the spread, thus creating a more efficient market.

6.1.4 Some side effects

Auctions are a method of squeezing out speculators from a transaction, but they may have their own perverse effects; see winner's curse. The winner's curse is however not very significant to markets with high liquidity for both buyers and sellers, as the auction for selling the product and the auction for buying the product occur simultaneously, and the two prices are separated only by a relatively small spread. This mechanism prevents the winner's curse phenomenon from causing mispricing to any degree greater than the spread.

Speculative purchasing can also create inflationary pressure, causing particular prices to increase above their true value (real value - adjusted for inflation) simply because the speculative purchasing artificially increases the demand. Speculative selling can also have the opposite effect, causing prices to artificially decrease below their true value in a similar fashion. In various situations, price rises due to speculative purchasing cause further speculative purchasing in the hope that the price will continue to rise. This creates a positive feedback loop in which prices rise dramatically above the underlying value or worth of the items. This is known as an economic bubble. Such a period of increasing speculative purchasing is typically followed by one of speculative selling in which the price falls significantly, in extreme cases this may lead to crashes. Overall, the participation of speculators in financial markets tends to be accompanied by significant increase in short-term market volatility. This is not necessarily a bad thing, as heightened level of volatility implies that the market will be able to correct perceived mispricings more rapidly and in a more drastic manner.
6.1.5 Call option

A speculator as a part of his trading may use call option or a put option. A call option is a financial contract between two parties, the buyer and the seller of this type of option. Often it is simply labeled a "call". The buyer of the option has the right, but not the obligation to buy an agreed quantity of a particular commodity or financial instrument (the underlying instrument) from the seller of the option at a certain time (the expiration date) for a certain price (the strike price). The seller (or "writer") is obligated to sell the commodity or financial instrument should the buyer so decide. The buyer pays a fee (called a premium) for this right.

The buyer of a call option wants the price of the underlying instrument to rise in the future; the seller either expects that it will not, or is willing to give up some of the upside (profit) from a price rise in return for the premium (paid immediately) and retaining the opportunity to make a gain up to the strike price.

Call options are most profitable for the buyer when the underlying instrument is moving up, making the price of the underlying instrument closer to the strike price. When the price of the underlying instrument surpasses the strike price, the option is said to be "in the money".

The initial transaction in this context (buying/selling a call option) is not the supplying of a physical or financial asset (the underlying instrument). Rather it is the granting of the right to buy the underlying asset, in exchange for a fee - the option price or premium.

Exact specifications may differ depending on option style. A European call option allows the holder to exercise the option (i.e., to buy) only on the option expiration date. An American call option allows exercise at any time during the life of the option.

Call options can be purchased on many financial instruments other than stock in a corporation. Options can be purchased on futures on interest rates, for example (see interest rate cap), and on commodities like gold or crude oil. A tradeable call option should not be confused with either Incentive stock options or with a warrant. An
incentive stock option, the option to buy stock in a particular company, is a right granted by a corporation to a particular person (typically executives) to purchase treasury stock. When an incentive stock option is exercised, new shares are issued. Incentive stock options are not traded on the open market. In contrast, when a call option is exercised, the underlying asset is transferred from one owner to another.

6.1.6 Strike price

In options, the strike price, or exercise price, is a key variable in a derivatives contract between two parties. Where the contract requires delivery of the underlying instrument, the trade will be at the strike price, regardless of the spot price (market price) of the underlying instrument at that time.

Definition - The fixed price at which the owner of an option can purchase, in the case of a call, or sell, in the case of a put, the underlying security or commodity.

6.1.7 Put option

A put option (sometimes simply called a "put") is a financial contract between two parties, the buyer and the writer (seller) of the option. The put allows the buyer the right but not the obligation to sell a commodity or financial instrument (the underlying instrument) to the writer (seller) of the option at a certain time for a certain price (the strike price). The writer (seller) has the obligation to purchase the underlying asset at that strike price, if the buyer exercises the option.

Note that the writer of the option is agreeing to buy the underlying asset if the buyer exercises the option. In exchange for having this option, the buyer pays the writer (seller) a fee (the premium). (Note: Although option writers are frequently referred to as sellers, because they initially sell the option that they create, thus taking a long position in the option, they are not the only sellers. An option holder can also sell his short position in the option. However, the difference between the two sellers is that the option writer takes on the legal obligation to buy the underlying asset at the strike price, whereas the option
holder is merely selling his short position, and is not contractually obligated by the sold option.)

Exact specifications may differ depending on option style. A European put option allows the holder to exercise the put option for a short period of time right before expiration. An American put option allows exercise at any time during the life of the option.

The most widely-known put option is for stock in a particular company. However, options are traded on many other assets: financial - such as interest rates (see interest rate floor) - and physical, such as gold or crude oil.

The put buyer either believes it's likely the price of the underlying asset will fall by the exercise date, or hopes to protect a long position in the asset. The advantage of buying a put over shorting the asset is that the risk is limited to the premium. The put writer does not believe the price of the underlying security is likely to fall. The writer sells the put to collect the premium. Puts can also be used to limit portfolio risk, and may be part of an option spread.