

FOREX

**An Insider's Guide to the Real World of
Foreign Exchange Trading**

Peter Rosenstreich

Library of Congress Catalog Number: 2001021 (Y7)

Illustrator: Bill Moon

Executive Editor: Bill Boyle

Editorial Assistant: Kate K. Stripling

Marketing Manager: Martin Litkowski

Informational Marketing Manager: Tim Calligan

Cover Designer: Alan Clark

Managing Editor: Gail Kanouse

Project Editor: Cathryn Hackford

Copy Editor: Mark Johnson

Indexer: Lili Silf

Collaborator: Tollman Creek Design

Manufacturing Manager: Dan Lirig



© 2005 by Pearson Education, Inc.

Published as Financial Times-Prentice Hall

Upper Saddle River, NJ 07455

Financial Times-Prentice Hall offers excellent discounts on this book when ordered in quantity for bulk purchases or special sales. For more information, please contact U.S. Corporate and Commercial Sales, 1-800-321-3111.

For sales outside the U.S., please contact International Sales at international@pearsoned.com.

Company and product names throughout herein are the trademarks or registered trademarks of their respective owners.

All rights reserved. No part of this book may be reproduced (in any form or by any means, without permission in writing from the publisher.

Printed in the United States of America

Third Printing, July 2005

ISBN 0-13-045000-0

Prentice Hall Ltd.

Prentice Hall Education Australia Pty. Limited

Prentice Hall Education Singapore Pte. Ltd.

Prentice Hall Education North Asia Ltd.

Prentice Hall Education Canada Ltd.

Prentice Hall Education de México, S.A. de C.V.

Prentice Hall Education Japan

Prentice Hall Education Malaysia Pte. Ltd.

and develop rich models, but that doesn't fundamentally alter the act.

Understanding this helps cut through the clutter, misperceptions, and mystery that surround this market. Very little of what is done in foreign exchange today is vastly different from how individuals have traded for thousands of years. The techniques and tools have changed, but the simple exchange remains the same.

Because foreign exchange is in fact so old, it is important to trace its roots, to explore how this market has evolved over the millennia. Individuals—kings and emperors, traders and dealers, common citizens and thieves—have employed all kinds of methods to use money and markets to their advantage. Their strategies have resulted in success and disaster. But all contain examples and lessons that will be helpful for the modern investor to understand this market.

This chapter also looks at the nature of money, how it has been used by different societies throughout history, and how its value can fluctuate. What emerges is the story of a long struggle between government and markets over who gets to control money—a struggle that continues to this day.

Lessons of History

One of the most famous and vivid channels of foreign exchange occurred along the fabled "Silk Road"—over which goods flowed back and forth between Asia, the Middle East, and Europe. The road started in Xian, a city in central China, and went by various trails west. Centuries ago, traders prodded columns of camels loaded with rugs, silks, and bags of aromatic spices that Europeans needed to season their dishes and delight their palates. Through the city's alleys and in its open market spaces, goods

entally alter

mispercep-
tion of what is
in how indi-
techniques and
the same.

important to
dred over the
and dealers,
kinds of meth-
their strategies
examples and
to understand

how it has been
how its value
tuggle between
ney—a strug-

were inspected, values suggested, and deals struck. Money and objects changed hands.

This kind of trade is the barter system, which is still the norm in many parts of the world. However, the barter system had flaws. For one, making individual trades was cumbersome and time-consuming. Each item had to be inspected and its worth determined before haggling could even begin.

Two, it was inefficient. Goods didn't always match up in value, so bartering required an extensive number of items to make the trade even. A bag of grain may not be exactly worth a lamb, so the trader would have to add a bottle of wine to even things out. This made things much more complex.

Three, the barter system could leave out vast parts of society. What happens if the farmer wants meat but doesn't need a pair of shoes? The farmer trades his grain with the butcher. But the shoemaker, who needs grain as much as the butcher, is left out.

There is a solution to the problems of the barter system, and many cultures developed it—currency.

The Roots of Modern Currency

Forget the idea that currency is a piece of colored paper with a picture of someone famous on it. Paper money as it now exists is a relatively new concept, and it probably won't survive our lifetimes. In cultural and historical terms, currency is something that any group mutually recognizes as valuable.

For example, the Aztecs prized cacao beans, which were used to make a delicious chocolate drink. Part of the beans' value derived from the fact that they were also practical. They could be transported relatively easily, were uniform, and made bartering simpler. If a trade was uneven, a merchant could throw in a scoop or two of beans.