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

Peter Rosenstreich

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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

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.