UBS Investment Bank

The History of the FX Market

The Depression through Bretton Woods

- Prior to the Great Depression
  - most currencies were freely exchanged
  - many had been convertible (via a gold or silver standard)
  - after the 1929 market crash, the metal convertibility waned
- As WWII came to an end -- Bretton Woods (N.H.) Conference (1944)
  - designed a new (hopefully stable) international monetary system
  - established the International Monetary Fund (I.M.F.) and World Bank
  - resolved to tie major currencies (via a par level) to the U.S. dollar
  - the U.S. dollar was then tied to gold (@ $35.00/oz.)
  - served to make the U.S.$ (USD) the primary reserve currency
  - individual countries responsible for maintaining their currency's value

The Fifties and Sixties

- In the 1950's
  - the advent of the TELEX helped facilitate these markets
  - since exchange rates were "fixed", only saw frenzied trading around devaluations or revaluations
  - these were known as "creeping pegs"
- In 1967, the GBP (British Pound) was attacked
  - the Bank of England fought (with the help of the other Central Banks) to protect the pound
  - they were unsuccessful; it was devalued in November of 1967
  - for the first time since the Bretton Woods conference, central bank intervention via currency market operations failed

The End of the Gold Standard

- In 1968, the U.S. dollar was under pressure
  - the DeutscheBank reluctantly absorbed billions of dollars to keep the DeutscheMark from appreciating, which it ultimately did in 1969
- By 1971, the U.S. dollar was in crisis
  - it was thought to be a depreciating currency
  - gold convertibility was suspended
  - Nixon imposed wage and price controls. Something had to give
  - in December 1971, the Smithsonian Agreement superceded Bretton Woods
  - gold was to be supported at $38.00; that is, the dollar was devalued
  - allowed currency valuation within a 2.25% central rate band (not a peg)

The Rise and Fall of the 'Snake'

- In 1972, in Europe
  - the E.E.C. attempted to narrow (halve) the band between their currencies ("the snake")
  - membership in this co-operative was voluntary
  - saw many countries come and go. It also failed
  - foreign exchange markets and market participants were maturing and using more sophisticated electronic equipment
  - DeutscheMarks continued to strengthen, Lira weakened, the snake died
- In 1973, the U.S. dollar was devalued by a full 10%
  - this was the beginning of floating exchange rates

The European Monetary System

- By the mid-1970’s, international (bank) brokers dominated FX markets
- In 1978-1979, the European Monetary System (EMS) was established
  - defined a new currency unit, the ECU (European Currency Unit)
  - set up the Exchange Rate Mechanism (ERM)
  - targets (within a band) each member currency at an ECU central level
- In 1982, Treasury Secretary Donald Regan vowed that the U.S. was through systematically intervening in the foreign exchange markets

Market Turmoil Starts in the mid-80s

- In 1985, the Plaza Accord (New York) with G-7 members attempted to lower the value of the U.S. dollar (which had returned to 1970 levels)
- By 1986, the dollar was down about 25% vs. the European majors
  - the U.S. dollar's fall had serious economic implications
  - many central banks intervened in 1987 to stop the dollar's fall
  - this type of activity is known as a "dirty float"
- In 1992, England and Italy withdrew from the EMS
  - ERM broke down
  - this same year, the Maastricht Treaty set up the European Union (in place of the old European Economic Community)

Modern Times

- In 1993, widened bands from 2.25% to 15%
  - effectively floating rates
- In 1999, Euro and ECB