Unit 1: Introduction to the Foreign Exchange Market

The Foreign Exhange (Forex) Market → The Key Market Participants → The Mechanics of Currency Trading

1.1 The Foreign Exchange (Forex) Market

The foreign exchange market – most often called the Forex Market, or simply the FX market – is the most traded financial market in the world. Forex trading is the simultaneous buying of one currency and selling of another. These two currencies make up what is known as a "currency pair," which is discussed in more detail further on in this unit.

The forex market is the largest financial market in the world, with an estimated daily trading volume exceeding $7.5 trillion as of 2024 (source: BIS, 2024). This high liquidity ensures that traders can enter and exit positions efficiently. The market operates 24 hours a day across major global financial centres, from Sunday 5 p.m. EST to Friday 4 p.m. EST. At any given time, at least one market is open somewhere in the world, ensuring continuous trading activity.

The forex market is the crossroads for international capital flows, forming the intersection through which global commercial and investment transactions move. It is essential for facilitating imports and exports, granting access to resources, and sustaining economic growth. Without forex trading, international trade and investment would be significantly constrained.

Participants in the Forex Market

In addition to central banks, commercial banks, hedge funds, and multinational corporations, individual retail investors also participate in the forex market. Retail investors engage in forex trading for:

- Speculation – Trading currency pairs with the objective of profiting from the difference in price movements.
- Portfolio diversification – Reducing local risk exposure by holding foreign currencies.
- Hedging – Protecting against currency fluctuations that could impact international business transactions or investments.

Originally, forex markets were primarily driven by international trade flows. Today, financial and investment flows dominate as the key contributors to forex trading volume. For example, a South African pension fund investing in U.S. Treasury bonds or a European conglomerate acquiring assets in South Africa will necessitate currency exchange transactions.

Technological advancements have democratized forex trading, allowing individual investors to trade through online trading platforms with real-time access to global markets.

Leverage and Margin in Forex Trading

One of the defining features of forex trading is leverage, which allows traders to control large positions with relatively small capital. Leverage ratios can be as high as 200:1 or greater, meaning that a trader can control R2 000 000 in forex positions with a margin deposit of just R10 000. However, margin requirements vary depending on the broker or jurisdiction.
While leverage magnifies potential gains, it also amplifies losses, making risk management an essential component of any trading strategy. Traders should implement stop-loss orders and use leverage cautiously to protect their capital.

Exchange Rate Systems

Currencies are traded based on one of three exchange rate regimes:

- Fixed exchange rates: The central bank pegs the currency to another currency or a basket of currencies.
- Floating exchange rates: The currency's value fluctuates based on market demand and supply.
- Pegged exchange rates: A hybrid system where the currency is allowed to fluctuate within a predetermined range.

Major Currency Pairs

Approximately 85% of all daily forex transactions involve the following major currency pairs:

- **EUR/USD** (Euro vs. US Dollar)
- **USD/JPY** (US Dollar vs. Japanese Yen)
- **GBP/USD** (British Pound vs. US Dollar)

- **USD/CHF** (US Dollar vs. Swiss Franc)

For South African traders, notable currency pairs include:

- **USD/ZAR** (US Dollar vs. South African Rand)
- **EUR/ZAR** (Euro vs. South African Rand)
- **GBP/ZAR** (British Pound vs. South African Rand)

Forex Market Hours

The forex market operates continuously from Monday morning in the Asia-Pacific region to the Friday close in New York. Unlike stock markets, forex trading does not pause for local holidays. For instance, even if South African markets are closed, trading may still be active in Sydney, Tokyo, or London.

Activity:

There are generally two main types of exchange rate systems, i.e. fixed and floating. What are some of the advantages of a fixed exchange rate?

Answer:

- Reduces uncertainty over currency fluctuations, fostering stability and confidence in international trade.
- Encourages foreign investment by providing a predictable exchange rate environment.
- Helps prevent excessive currency devaluation, which can contribute to lower inflation and economic stability.

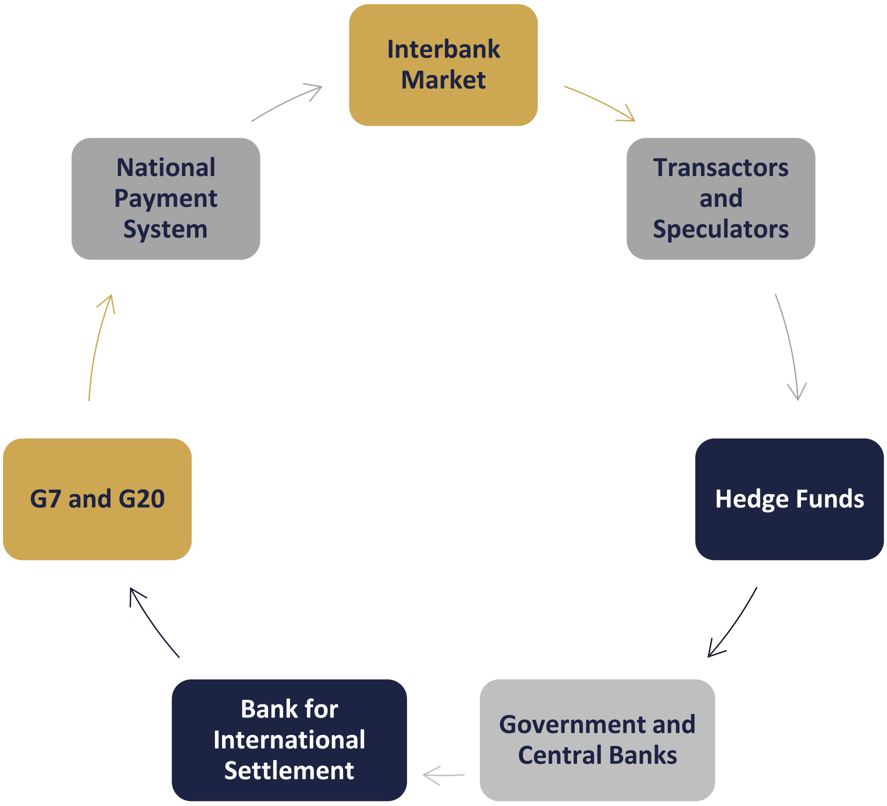
1.2 The Key Market Participants

The forex market originally evolved to facilitate trade and commerce between nations. The leading international commercial banks, which financed international trade through letters of credit and bankers' acceptances, were the natural financial institutions to act as the currency exchange intermediaries and facilitate the currency transfers needed to settle forex transactions.

Over time, other major participants have emerged in the forex market. These participants include:

- **Central Banks** – Institutions such as the South African Reserve Bank (SARB) and the U.S. Federal Reserve influence currency values through monetary policy, interest rate adjustments, and foreign exchange interventions.
- **Commercial and Investment Banks** – These banks execute forex transactions on behalf of clients and their own trading operations. They act as market makers, providing liquidity and facilitating global currency trades.
- **Multinational Corporations** – Companies engaged in international business require forex transactions to manage revenue, expenses, and hedging against currency fluctuations.
- **Hedge Funds and Speculators** – Large institutional investors and hedge funds participate in forex trading with the goal of capitalizing on short- and long-term market movements.
- **Governments and Sovereign Wealth Funds** – National governments and their investment arms manage forex reserves, intervene in currency markets, and influence global exchange rate dynamics.
- **Retail Forex Traders** – Individual investors participate through online trading platforms, utilizing leverage and technical strategies to trade currencies.

The below diagram illustrates the key participants in the forex market:



1.2.1 The Interbank Market

The result over the years was the development of an informal interbank market for currency trading. As the prefix suggests, the *interbank* market is "between banks," with each trade representing an agreement between the banks to exchange the agreed amounts of currency at the specified rate on a fixed date. The interbank market is alternatively referred to as the *cash market* or the *spot market*, to differentiate it from the currency futures market, which is the only other organised market for currency trading.

The big commercial banks were the key role-players when it came to currency trading, whereas investment banks remained primarily focused on trading stocks and bonds. Despite this, the banking industry has undergone a tremendous consolidation over the last 20 years, with a number of major mergers and acquisitions resulting in well-known banking names being absorbed into massive financial conglomerates. Today it is difficult to consider any of the major banks as either commercial banks or investment banks only, such has been the expansion of their trading operations.

While banks formed the core of the interbank market for decades, non-bank financial institutions, like hedge/ pension/ mutual funds, steadily increased their activity in the forex market. The rise in electronic trading technology in recent years has only increased the market presence of these firms.

Interbank trading rooms are staffed by a variety of different market professionals, and each has a different role to play.

These typically include:

- **Flow traders**

Sometimes called *execution traders,* these are the market-makers, showing two-way prices at which to buy and sell, for the bank's customers. If the customer makes a trade, the execution trader then has to cover the resulting deal in the interbank market, hopefully at a profit. These traders are also responsible for watching and executing customer orders in the market. These are the traders who are generating most of the electronic prices and price action.

- **Proprietary traders**

These traders are focused on speculative trading for the bank's own account. Their strategies can run a full spectrum from short-term day trading to longer-term macro-economic bets.

- **Forward traders**

Forward traders are active in the *forward* currency market, which refers to trades made beyond the normal spot value date. The forward market is essentially an interest-rate differential market, where the interest rates of the various currencies are traded. These traders provide the bank's customers with pricing for non-spot deals or currency-swap agreements. They also manage the bank's interest-rate exposure in various currencies.

- **Options traders**

Options traders manage the bank's portfolio, or book, of outstanding currency options. They hedge the portfolio in the spot market, speculate for the bank's own account with option strategies, and provide pricing to the bank's customers on requested option strategies.

1.2.2 Transactors and Speculators

Participants in the forex market generally fall into one of two categories:

- financial transactors
- speculators

Financial transactors are active in the forex market as part of their overall business but not necessarily for currency reasons.

Speculators are market participants who are involved in the market for one reason only – to make money off directional price movements. In contrast to hedgers, who have some form of existing currency market risk, speculators have no currency risk until they enter the market.

Hedgers enter the market to mitigate or reduce risk. Speculators embrace risk-taking as a means of profiting from long-term or short-term price movements.

Speculators (‘*specs*’ for short) are what really make a market efficient. They add liquidity to the market by bringing their views and, most important, their capital, into the market. That liquidity is what smooths out price movements, keeps trading spreads narrow, and allows a market to expand.

1.2.3 Hedge Funds

A hedge fund is an investment fund that pools capital from accredited individuals or institutional investors and invests in a variety of assets, often with complex portfolio construction and risk-management techniques. Hedge funds often promise great returns, but this is often met with greater levels of risk.

1.2.4 Governments and Central Banks

National governments are active in the forex market for routine funding of government operations, making transfer payments, and managing foreign currency reserves. In South Africa, The South African Reserve Bank (SARB) is responsible, on behalf of the Minister of Finance, for the day-to-day administration of exchange controls in South Africa. Exchange Control Regulations are the legal provisions that limit the extent to which South African residents and companies may transfer funds abroad.

1.2.5 The Bank for International Settlements

The Bank for International Settlements (BIS) is the central bank for central banks. Located in Basel, Switzerland, the BIS also acts as the quasi-government regulator of the international banking system.

As the bank to national governments and central banks, the BIS frequently acts as the market intermediary of those nations seeking to diversify their currency reserves. By going through the BIS, those countries can remain relatively anonymous and prevent speculation from driving the market against them.

In South Africa in particular, the National Payments System is one of the pillars of financial stability of the economic system. The Reserve Bank oversees the safety and soundness of the national payment system and implements risk-reduction measures in the payment system to reduce systemic risk.

The Reserve Bank provides an inter-bank settlement service via the real-time electronic settlement system, the South African Multiple Option Settlement (SAMOS) systems. Besides single settlements between banks, SAMOS is also used for the settlement of obligations arising out of retail payment clearing and the Equity and Bond markets.

1.2.6 The G7 and G20

The Group of Seven, or G7, is composed of the seven largest developed economies in the world:

- Canada
- France
- Germany, Italy
- Japan
- United Kingdom
- United States

Together they account for a little over half of global GDP (Gross Domestic Product), down from nearly two-thirds in 2000. The fall in their relative share of global GDP is the result of economic weakness following the GFC (Global Financial Crisis) and the coincident outperformance of major emerging economies in the subsequent recovery.

The G7 used to be the primary venue for the major global powers to express their collective will on currency values and the need for any adjustments, with past G7 statements frequently triggering major realignments. In 2008, the G7 ostensibly ceded control over currency matters to a larger grouping of economies, the G20, in recognition of globalisation and the rise of economies like Brazil, Russia, India, and China.

The G7 remains a potent force, and traders would be well advised to pay attention to the quarterly gatherings of G7 finance ministers and central bank chiefs and indications that currencies may be on the agenda.

The G20 consists of:

- the G7
- Australia
- Turkey
- Russia
- Saudi Arabia
- Indonesia
- India
- South Korea
- China
- Brazil
- Argentina

- Mexico
- South Africa
- representation from the European Union

Together, the G20 nations account for approximately 85% of global GDP and two-thirds of the world's population.

As a global decision-making body, the G20 operates on a consensus-based approach, which allows for broad participation but also makes it harder to reach decisive agreements—especially on currency policies.

While the G20 is a more inclusive economic forum, its effectiveness in influencing currency markets has been more limited compared to the G7 due to:

- The diverse economic interests among its members.
- The challenges of securing agreement across 20 nations with differing priorities.

Take Note

The G7 historically played a key role in shaping global currency markets but has since shifted some of this responsibility to the G20. The G7 remains relevant, particularly during quarterly finance meetings, where currency-related discussions may still influence forex markets. The G20 represents a much larger share of the global economy, but its consensus-based structure makes it less decisive in currency-related decision-making.

1.3 The Mechanics of Currency Trading

The forex market has its own set of trading conventions, like how prices are quoted, and orders executed, just like any other financial market. However, when it comes to currency trading, the purchase of one currency involves the simultaneous sale of another currency. This is the '*exchange'* in *foreign exchange.*

As discussed earlier, the currency being bought and the currency that is being sold make up a "currency pair," where each currency is made up by three letters. The US dollar is the central currency against which other currencies are traded, being the primary international reserve currency.

The table below illustrates the major US dollar currency pairs. The major currency pairs all involve the US dollar on one side of the deal. The designations of the major currencies are expressed using International Standardization Organization (ISO) codes for each currency. “Table 1” lists the most frequently traded currency pairs, what they are called in conventional terms, and what nicknames the market has given them.

Take Note

The first two letters represent the country, and the third letter identifies the currency.

The currency to the left of the slash (/) is called the **base currency**, and the currency to the right is called the **counter or quote currency**.

Table 1: The major US Dollar currency pairs

Pair	Countries	Nickname
EUR/USD	Euro zone / United States	Euro dollar
USD/JPY	United States / Japan	Dollar yen
GBP/USD	United Kingdom / United States	Pound dollar
USD/CHF	United States / Switzerland	Dollar swiss
USD/CAD	United States / Canada	Dollar loonie
AUD/USD	Australia / United States	Aussie dollar
NZD/USD	New Zealand / United States	Kiwi dollar

Example:

Let us take a look at the EUR/USD currency pair ‘EUR/USD = 1.23700’:

- The currency to the left of the slash (“ / ”) is called the base currency (in this example, the euro), and the currency on the right is called the quote currency (in this example, the US dollar).
- This notation means that 1 unit of the base currency (that is, 1 euro) is equal to 1.23700 US dollars.
- You have to pay 1.23700 US dollars to buy 1 euro.
- If selling, the foreign currency exchange rate specifies how many units of the quote currency you get for selling one unit of the base currency.
- In the above example, you will receive 1.23700 US dollars when you sell 1 euro.

1.3.1 Long and Short Positions

When you buy a security, you are said to have taken a long position, or simply, you are long that security. In forex markets, this means you have purchased a currency pair intending to profit when the price moves up so you can sell at a higher price. So, when a trader executes a buy order, the trader holds a long position in the instrument they bought for example the USD/ZAR. The trader, therefore, expects the US Dollar to appreciate against the South African Rand.

A short position is the opposite of a long position. When a trader shorts a currency, the expectation is that the price of the underlying currency will depreciate. Shorting a currency means selling it with the hope that the price will fall in the future, so it can be bought back at a later date, at a lower price. If a trader shorts USD/ZAR, the trader is selling USD to buy ZAR.

Take Note

"Selling high and buying low" is a standard currency trading strategy.

Activity:

What do you think is the ISO code for the South African rand?

Answer:
The ISO code for the South African rand is called the "ZAR."

1.3.2 Profit and Loss

Traders need to understand how to measure their profits or losses. This is particularly so with margin trading where your profit or loss can affect the amount of margin balance, which in turn determines how much and for how long you can trade if prices move against you.

1.3.3 Margin Balances and Liquidations

In forex trading, the use of leverage can help you to gain a large exposure to a currency with a small amount of your capital. This initial capital is called the margin, which becomes your opening balance and the basis on which your subsequent trades are collateralised. The broker will set the ratio of margin balances to open positions, and this must be maintained at all times.

If your margin balance falls below the required ratio, your broker may close your positions without even notifying you, but this usually happens only when an account has losing positions. If your position is liquidated, this locks in your losses and your margin balance declines. It is therefore important for traders to understand the margin requirements and liquidation policies of their brokers.

1.3.4 Unrealised and Realised Profit and Loss

You can estimate your unrealised profit or loss through mark-to-market calculation. This will show you where you could close your open positions at that moment. If you have opened long positions, the mark-to-market calculation will usually be based on where you can sell at that instant. If you have short positions, the calculations will be based on where you can buy at that instant. The margin balance will be the sum of the initial margin deposit, the unrealised profit or loss and the realised profit or loss.

Realised profit or loss is what you get when you close your position or a part of your position. Once you close out your full position, the profit or loss you made leaves the unrealised profit and loss calculation and goes into your margin balance. If you close a part of your positions, only what you made from that trade goes to the margin balance and your unrealised profit or loss as well as your total margin balance will continue to fluctuate based on your opened positions.

1.3.5 Bids and Offers

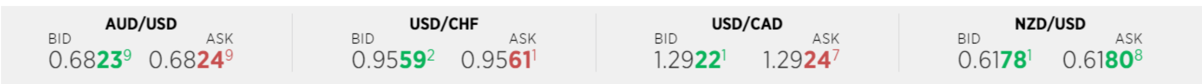
For each currency pair, there are two prices: the bid price and the offer price. The price on the left-hand side is the bid and the offer (or the ask) price is on the right-hand side. Some brokers display the prices vertically, with the offer on top and the bid at the bottom. Regardless of how the prices are displayed, the bid is always lower than the offer price.

For each bid and offer price, there are two components:

- the big figure (also called the big fig or the handle) and
- the dealing price.

The big figure is the first three digits of the quoted price, and the dealing price is the last two digits of the quote. The dealing price is usually displayed in bright colours or larger font sizes. The figure below shows the big fig, and the dealing price as displayed on Forex.com

Figure 1: Bid-off Display on Trade Online with an Award-winning Global Forex Broker - FOREX.com



1.3.6 Spreads

The difference between the bid price and the offer price is called the spread, which is essentially, the commission that the broker charges for being a market-maker. In general, the more liquid currency pairs have narrower spreads than the less liquid pairs.

1.3.7 Orders

Since currency markets operate round the clock, a trader is likely to miss important market-moving events unless such a trader also works around the clock. Since it is impossible to work round the clock, traders implement orders, which allow them to automate some trading decisions hence staying in the loop even while they are not physically present to trade.
Currency traders use orders for different objectives.

Some of the main reasons for using orders are:

- To execute a trading strategy
- To limit risk in volatile or uncertain market conditions
- To capture sharp, short-term price fluctuations
- To protect trading capital from certain losses
- To maintain trading discipline
- To minimise losses and protect profits

Forex markets, just like other financial markets, can sometimes experience periods of high uncertainty and volatility. Stop orders can help traders to limit the impact of any sharp downward price movements. They can also be employed to capitalise on short-term market movements and to quantify the risk the trader is taking.

Types of orders

The list of orders discussed here is not exhaustive. However, some of the most common orders are:

- **A market order:**

This order is the most basic type of order and executes at the best available price at the time the order is received.

- **A limit order:**

This order is also called a “take profit” order. It is an order to buy or sell at a specified price or better. While a buy limit order will execute at the specified price or lower, a sell limit order executes at the specified price or higher.

- **A stop order:**

A stop order also called a stop loss order, executes a market order once a specified rate (called the stop price) is reached. Once the stop price is reached, the stop order becomes a market order. Traders generally use buy-stop orders to limit losses or to protect profits on currencies they have sold short. A sell-stop order initiates a market order when a predefined bid price is met, while a buy-stop order initiates a market order once a specified offer price is met. Stop orders are executed at the best price available, subject to liquidity.

- **A trailing stop:**

This is a stop order based on a specified number of pips[1] away from the current market price. When the market moves in your favour, a trailing stop order trails your position automatically. If the market moves against you by the specified number of pips, it triggers a market order, and at the next available rate (subject to liquidity), the stop order is executed. A trade with a short position will set the trailing stop above the current market price, while a trader with a long position will set the trailing stop loss below the current market price. A trailing stop is aimed at protecting gains by allowing the position to stay open if the price is moving in the trader's favour and closes if the market moves against the trader by a specified percentage or rand amount.

- **Contingent orders:**

Contingent orders combine different orders and require one of the orders to be executed before the other order is activated. The most common types are If/Then and If/Then OCO.

- ***An if/then order*:**

This contingent order is made up of two orders and designed so that if the first order (the "if" order) is executed, the next order (the "then" order) becomes an active, unattached, single order. Unattached orders are not attached to a trade and act independently of any position updates. In the situation where the "if" order is not executed, the "then" order becomes dormant hence it will not be executed when the market reaches the predefined rate. Also, if any part of and if/then order is cancelled, this cancels the other part of the order as well.

- ***An if/then OCO:***

This contingent order is designed so that once the first order (the "if" order) executes, the second order (the "then" order) becomes an active unattached one-cancels-other (OCO) order. Just like the regular OCO order[2], executing one of the two "then" orders automatically cancel the other. If the "if" order is not executed, the "then" OCO order remains dormant and will not execute when the market reaches the specified rate. When one part of the if/then OCO order is cancelled, all other parts of the order will also be cancelled.

[1] A 'pip' (point in percentage) is the smallest unit increment in which a currency pair can move. For most of currency pairs, a pip is the fourth digit after the decimal point.

[2] A one-cancels-the-other (OCO) order is a pair of conditional orders with the instruction that if one order is executed, then the other order will be cancelled automatically.

Unit 1 Summary

The foreign exchange market—commonly known as the forex market or FX market—is the most actively traded financial market in the world. It serves as the central hub for global capital flows, facilitating both commercial and investment transactions across borders. At its core, currency trading involves speculating on the value of one currency relative to another.

Currency trading is a form of speculation, much like buying stocks or other financial assets with the expectation of making a profit. However, instead of investing in companies, traders are speculating on the value of different national currencies. This means that forex trading is influenced by both market speculation and the economic and political factors that drive currency values.

The forex market initially developed to support international trade and commerce. Large commercial banks, which facilitated global trade through letters of credit and bankers' acceptances, naturally became intermediaries in foreign exchange transactions. These institutions played a crucial role in managing currency transfers and ensuring that cross-border trade settlements were completed efficiently.

The key participants in the forex market include:

- **Interbank Market** – The primary network through which banks exchange currencies, setting the benchmark for global forex rates.
- **Transactors and Speculators** – Businesses, institutional investors, and individual traders who buy and sell currencies for commercial or speculative purposes.
- **Hedge Funds** – Large investment funds that use forex trading as part of their broader investment strategies.
- **Governments and Central Banks** – National authorities that manage monetary policy and intervene in currency markets when necessary.
- **South African Reserve Bank (SARB)** – The central bank responsible for managing South Africa's currency policy and ensuring financial stability in the local forex market.
- **Bank for International Settlements (BIS)** – An international financial institution that serves as a central bank for central banks, supporting global financial stability.
  G7 and G20 – Economic forums where major economies coordinate financial and currency-related policies.

Like other financial markets, the forex market operates with its own trading conventions, including specific methods for quoting prices and executing orders. Understanding these conventions is essential for anyone participating in currency trading.

Unit 2: The Economic Context

Economic Fundamentals → Risk Appertite Indicators and Exhange Rates → Measuring Risk-off and Risk-on → Identifuing Shifts in Investor Sentiment

2.1 Economic Fundamentals

Information is the driving force behind every financial market, and the forex market has a unique set of influencing factors. Currency values fluctuate continuously based on a combination of economic, financial, and geopolitical events. Key influences include financial crises, central bank interest rate decisions, and economic growth data.

Unlike stock markets, which focus primarily on company performance, the forex market determines the relative value of currencies. This makes it essential to consider multiple economic and political themes that affect at least two major economies at any given time.

The forex market is shaped by fundamental economic indicators, which provide insights into a country's economic health and financial stability. Traders and investors analyse these fundamentals to anticipate currency movements and make informed trading decisions.

Key Economic Fundamentals:

Several core economic factors influence exchange rates:

- Economic cycles and data reports – The phases of economic growth and contraction, along with reports that assess overall economic conditions.
- Interest rate levels – The cost of borrowing money, which directly affects capital flows and currency demand.
- Monetary policy – The actions taken by central banks to regulate economic growth and inflation, including adjusting interest rates, and controlling money supply.

- Inflation – The rate at which prices rise over time, affecting purchasing power and currency stability.
- International trade flows – The movement of goods and services between countries, influencing supply and demand for currencies.
- International investment flows – The movement of capital across borders, including foreign direct investment (FDI) and portfolio investments.
- Political and geopolitical developments – Events such as elections, trade agreements, conflicts, and sanctions that impact investor confidence and market stability.

A critical factor in determining a currency's value is the level of investor confidence. If major national events—such as political instability, economic crises, or elections—create uncertainty, investors may move their capital to safer assets, causing the currency to weaken.

The Global Financial Crisis (GFC) of 2008–2009 demonstrated how interconnected global markets are, leading to widespread currency volatility. More recently, events such as the COVID-19 pandemic and geopolitical tensions, including the Russia-Ukraine war, have reinforced these dynamics, significantly affecting forex markets worldwide.

For the purposes of this module, the following economic fundamentals will be discussed in greater detail:

- Economic cycles
- Economic data, including political and geopolitical aspects
- Interest rates
- Monetary policy
- Inflation

Take Note

The general characteristics of each of these fundamentals will be discussed. In addition, we will explore the general effect of these fundamentals on a country's currency for learning purposes. These fundamentals, in reality, combine to influence a country's exchange rate.

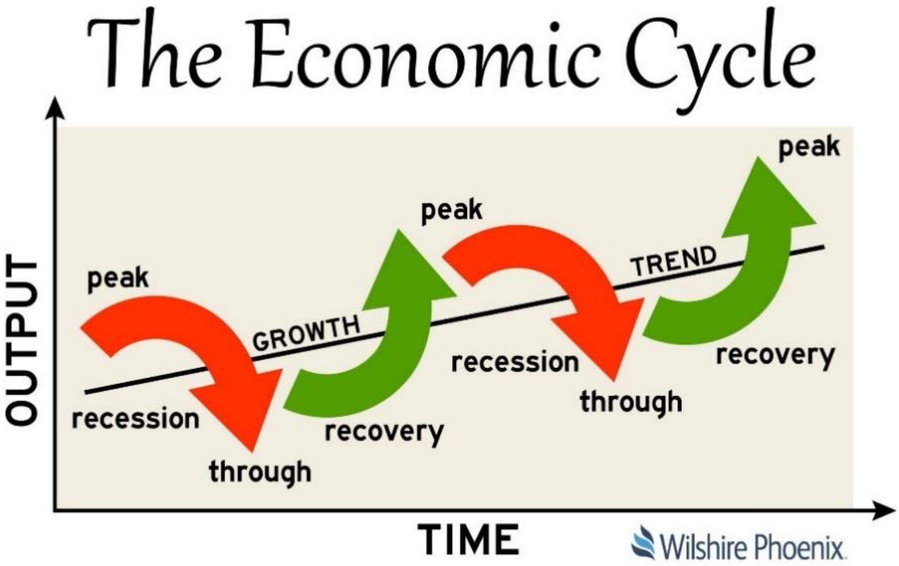
2.1.1 Economic Cycles

An economic cycle, also referred to as a business cycle, describes the fluctuations in a country's economic activity over time. These cycles consist of alternating periods of economic expansion and contraction, which influence employment levels, consumer spending, investment activity, and currency value.

Phases of the Economic Cycle:

- **Recession (Downturn)** – Economic decline marked by falling consumer and business spending, rising unemployment, and declining investment.
- **Trough** – The lowest point in the cycle, where economic indicators stabilize at their weakest levels before recovery begins.
- **Recovery (Upturn)** – The economy begins to improve, leading to increased business activity, employment, and investment.
- **Peak** – The highest level of economic growth before a slowdown occurs, often characterized by inflationary pressures.

These phases continuously repeat over time, though the duration and intensity of each phase can vary due to external factors such as government intervention, global economic conditions, and technological advancements. The diagram below shows how these phases occur.



A. Recession (Downturn) Phase

A **recession** occurs when economic activity contracts for an extended period, often defined as two consecutive quarters of negative GDP growth. During this phase, prices for goods and services may become unaffordable, causing consumers to reduce spending. Businesses experience lower sales, leading to decreased investment and rising unemployment.

Factors that may Worsen a Recession include:

- **Declining commodity prices**, particularly in resource-rich economies like South Africa, where exports play a key role in economic growth.
- **Natural disasters**, such as severe droughts or floods, which disrupt agricultural and industrial production.
- **Political instability**, which can reduce investor confidence and cause capital flight.

- **Global economic slowdowns**, which reduce demand for exports and foreign investments.

Key Indicators of a Recession:

- Investor confidence declines.
- Consumer and business spending decreases.
- Investment and industrial production fall.
- Unemployment rates rise significantly.

In extreme cases, a prolonged and severe recession may develop into a **depression**, characterized by a collapse in economic activity, soaring unemployment, and declining business profits. During this time, central banks typically intervene by **cutting interest rates** to encourage borrowing and spending, helping to stimulate economic recovery.

At the **trough**, the economy reaches its lowest point, and key indicators such as production and employment stabilize.

B. Recovery (Upturn) Phase

The **recovery phase** marks the beginning of economic improvement. A stabilized socio-political environment, positive global economic trends, and government interventions contribute to restoring confidence in the economy.

In the **early recovery stage**, investors may remain cautious, preferring safer assets such as bonds or interest-bearing deposits. However, as economic conditions improve, they shift toward riskier investments, such as equities and property.

Key Indicators of an Economic Recovery:

- **Increased global economic growth**, leading to higher demand for South African exports.
- **Improvement in the current account balance**, as exports recover and foreign investments flow back into the economy.
- **Higher consumer spending**, particularly on durable and semi-durable goods like vehicles, furniture, and household appliances.
- **Increased employment**, as businesses expand operations to meet rising demand.
- **Rising foreign exchange reserves**, reflecting improved investor confidence and capital inflows.

As the recovery phase progresses, businesses ramp up production to meet growing demand. Investments in capital goods, such as machinery and infrastructure, increase as firms prepare for sustained growth. Employment rises, allowing consumers to regain purchasing power, further stimulating economic expansion.

At the **peak** of the economic cycle, growth stabilizes as key indicators—such as employment, production, and profits—reach their highest levels. However, rising prices and interest rates may begin to reduce consumer demand, potentially triggering the next downturn.

Example (2024/2025): South Africa experienced a moderate recession in 2023 due to high interest rates and persistent energy constraints. However, by mid-2024, improvements in energy supply and stronger global demand for South African exports signalled the early stages of recovery. Investor confidence rebounded, leading to increased capital inflows, and renewed economic growth expectations.

2.1.2 Economic Data Reports

Daily, currency traders have to sort through a myriad of economic reports, interpret the comments of political and financial officials from around the world, take stock of geopolitical developments, and assess movements in other financial markets. They do all this to help them determine in what direction major currencies are likely to move.

Getting up to speed in the forex market means learning what current themes are driving the market. To do that, you are going to need to know where to find market information and how to interpret it.

Economic data can be found on credible news sources such as:

- Bloomberg www.bloomberg.com
- MarketWatch.com www.marketwatch.com
- Reuters www.reuters.com

Please Take Note

When reading a market news report, always use a critical eye. Keep in mind that what is being reported has already happened, and the market has digested the information and adjusted prices accordingly.

The following factors are usually taken into consideration when analysing market data:

The source of the information:
Traders need to differentiate fact from opinion or merely a rumour.

How relevant the information is:
Traders need to gauge the timeliness of the information and the extent to which the market has already (re-)acted on it.

i. Real-time Market News Sources

The forex market reacts swiftly to news, with institutional traders often relying on multiple real-time news feeds from major accredited sources such as Dow Jones, Bloomberg, and Reuters. Individual traders can also access real-time updates, particularly economic data releases, via financial news networks like Bloomberg TV, CNBC, and Fox Business News. Additionally, social media platforms such as Twitter (X) and financial forums are increasingly used by forex brokers to disseminate news, insights, and research.

ii. Currency Forecasts

Financial media frequently publish institutional forecasts predicting future currency movements. However, these projections should be viewed as **market sentiment indicators** rather than definitive trading signals. Forecasts are often influenced by current economic and political conditions, making them more reflective of short-term expectations than reliable long-term predictions.

iii. Market Rumours

Market rumours involve speculation about economic data releases **before their official publication**—sometimes emerging minutes or hours in advance. These rumours can disrupt short-term trading strategies and influence how the market reacts once the actual data is released.

For example, a **rumoured** South African economic report suggesting weaker-than-expected performance could put downward pressure on the South African rand (ZAR) before the official release. However, if the actual data aligns with expectations or is slightly better than the rumoured figure, the ZAR may rebound as initial fears subside. The challenge with market rumours is that their accuracy is often unverifiable, and price reactions can be unpredictable.

2.1.3 Currencies and Interest Rates

The most significant overall determinant of a currency's value relative to other currencies is the monetary policy set by a country's central bank. This is because monetary policy directly influences domestic interest rates, which in turn affect exchange rates by driving capital flows between different economies.

Domestic interest rates play a critical role in shaping overall economic activity. When interest rates are lower, borrowing becomes cheaper, encouraging businesses and individuals to take on loans for investment and consumption. This can lead to economic expansion but may also weaken a currency as investors seek higher returns elsewhere. Conversely, when interest rates rise, borrowing becomes more expensive, slowing down consumption and investment. However, this can strengthen a currency as investors move capital into the higher-yielding economy.

Interest rates are essential because they act as a benchmark for global investors deciding where to allocate capital. Currencies linked to higher yields (higher interest rates) generally appreciate, as they attract capital inflows from investors looking for better returns. On the other hand, currencies tied to lower yields (lower interest rates) often depreciate due to reduced investor demand.

However, market expectations of future interest rate movements often have a stronger impact on currency values than the current interest rate itself. Forex traders focus more on where rates are expected to move rather than their present level. If investors anticipate that a central bank will raise interest rates in the near future, the currency may start appreciating even before the rate hike happens. Similarly, if rate cuts are expected, the currency may begin to weaken in advance.

The timeframe in which interest rate changes are priced into the market can span months or even years, depending on global economic conditions and monetary policy guidance. Market participants continually adjust their forecasts based on new economic data and central bank announcements, causing fluctuations in exchange rates.

i. Relative Interest Rates

Currencies are always traded in pairs, meaning forex traders do not focus on a single country's interest rate in isolation. Instead, they compare *interest rate differentials* between two economies.

For example:

- If the U.S. Federal Reserve is expected to raise interest rates faster than the European Central Bank, the USD may strengthen against the EUR.
- If both central banks raise rates by the same magnitude, the impact on the exchange rate may be minimal.

Traders analyse these relative movements to determine whether one currency will appreciate or depreciate against another.

ii. Interest-Rate Differentials

The *interest-rate differential (spread)* is the gap between the interest rates of two countries. A widening interest-rate differential favours the higher-yielding currency, making it more attractive to investors.

A narrowing interest-rate differential makes the lower-yielding currency more competitive and may lead to depreciation of the higher-yielding currency.

Interest-rate differentials are closely monitored in *carry trading*, where traders borrow in a low-interest-rate currency (e.g., JPY or CHF) and invest in a high-interest-rate currency (e.g., ZAR or BRL) to profit from the spread.

iii. Nominal and Real Interest Rates

Not all interest rates are equal in importance. Forex markets focus on *real interest rates*, which account for *inflation-adjusted returns*.

- **Nominal interest rate**: The base interest rate set by a central bank.
- **Real interest rate**: The nominal interest rate **minus** inflation.

For Example:

- If a bond offers an **8.5% nominal yield**, but inflation is **4.5%**, the **real yield is only 4%**.
- In economies experiencing **hyperinflation**, nominal interest rates may be **extremely high** (e.g., 20%), but if inflation is even higher (e.g., 25%), the **real return is negative (-5%)**, leading to **capital flight** and currency depreciation.

Conversely, a country with **zero nominal interest rates** but **deflation** (negative inflation) can have a **positive real interest rate**, making its currency **attractive** despite low yields.

For example:

- If **inflation is -2% (deflation)** and the nominal interest rate is **0%**, the **real rate is 2% (0 - (-2) = 2%)**, which could strengthen the currency.

Activity:

What factors are likely to drive interest rate expectations?

Answer:

The evolving economic outlook is based on incoming data assessments and guidance by monetary policymakers, and a host of other economic, fiscal, and political developments.

2.1.4 Inflation

Currency traders closely monitor **inflation** as it plays a significant role in determining exchange rate movements. Inflation does not always have a **uniform** effect on a currency's value—it can either strengthen or weaken a currency depending on broader economic conditions and monetary policy responses.

Example:

"The rate of inflation in a country can have a major impact on the value of the country's currency and its exchange rate against other currencies. Inflation is just one of many factors that influence exchange rates.

Inflation is more likely to have a negative effect rather than a positive effect on a currency's value. While a very low inflation rate does not necessarily guarantee a favourable exchange rate, high inflation almost always weakens a currency by reducing its purchasing power and eroding investor confidence.

Inflation is closely linked to interest rates, which in turn affect exchange rates. Central banks attempt to balance inflation and interest rates, but this relationship is complex and difficult to manage. Low interest rates encourage consumer spending and economic growth, which may temporarily support a currency. However, if demand outpaces supply, inflation can rise sharply, leading to a potential currency depreciation.

The impact of inflation on exchange rates was evident in 2023–2024 when the U.S. Federal Reserve and the European Central Bank (ECB) took different approaches to inflation control. The Fed maintained higher interest rates for longer to curb inflation, which supported the U.S. dollar (USD). Meanwhile, the ECB took a softer stance on inflation, leading to a weaker euro (EUR) as investors moved capital toward the USD. Similarly, emerging market currencies, such as the South African rand (ZAR) and Turkish lira (TRY), suffered depreciation in 2024 as inflationary pressures led to capital outflows.

Ultimately, the perceived desirability of holding a nation's currency is the key factor in determining exchange rates. This perception is shaped by various economic indicators, including inflation, interest rates, and political stability. Investors prioritise the safety of their capital—if a country is viewed as politically or economically unstable or if there is a significant risk of currency devaluation, investors may avoid holding that currency for extended periods.

Source: Investopedia; Accessed: 28 January 2025; Available at: https://www.investopedia.com/ask/answers/022415/how-does-inflation-affect-exchange-rate-between-two-nations.asp

2.1.5 Monetary and Fiscal Policy

Monetary policy refers to the policy actions undertaken by central banks—such as the South African Reserve Bank (SARB)—to fulfil their legal mandates. Most central banks operate under legislative frameworks that focus on two primary objectives:

- Promoting price stability (restraining inflation)
- Promoting sustainable economic growth, often with an explicit goal of achieving maximum employment

At a broader level, a country's macro-economic policy aims to ensure sustainable and balanced economic growth, improve employment opportunities, and control inflation. Policymakers use two main tools to achieve these objectives: fiscal policy and monetary policy.

Fiscal Policy

Fiscal policy is formulated and executed by the government to influence the economy through changes in public expenditure and taxation.

When economic activity slows down and unemployment rises, governments often adopt an expansionary fiscal policy. This involves:

- Increasing government spending – Funding infrastructure projects, education, or social services to stimulate economic activity.
- Reducing taxes – Providing tax relief to individuals and businesses, thereby increasing disposable income, and boosting consumer spending.

These measures generally promote economic growth and often lead to higher stock prices. However, expansionary fiscal policy can also result in higher budget deficits, which may drive up government debt levels and inflation.

Example:

In response to the economic slowdown in 2023–2024, several governments—including those in the United States and South Africa—implemented fiscal stimulus measures such as tax breaks and increased public spending.

While these measures supported short-term economic recovery, they also contributed to higher inflation and rising national debt levels.

Monetary Policy

Monetary policy involves measures used by central banks to regulate the economy, primarily by controlling money supply and interest rates. These measures aim to stabilise inflation and ensure balanced economic development.

The Role of the South African Reserve Bank (SARB)

In South Africa, the SARB plays a key role in implementing monetary policy. It does so by:

- Controlling the money supply – Through open market operations such as buying or selling government debt securities.
- Regulating credit availability – By adjusting the Repo rate (the interest rate at which SARB lends to commercial banks).

- Influencing commercial lending rates – The prime lending rate (Repo rate + 3.5%) directly affects consumer borrowing costs.

Types of Monetary Policy:

1. **Restrictive (Tight) Monetary Policy:**
    - Objective: Reduce inflation by limiting the money supply.
    - Methods: Increasing interest rates, reducing credit availability.
    - Impact: Slows down spending and investment, leading to lower inflation but possibly slowing economic growth.

2. **Expansionary Monetary Policy:**
    - Objective: Boost economic activity by increasing the money supply.
    - Methods: Lowering interest rates, increasing lending capacity.
    - Impact: Stimulates economic growth but may lead to inflation if demand outpaces supply.

If SARB raises interest rates, borrowing becomes more expensive, leading to lower consumer spending and reduced inflation. However, if SARB lowers interest rates, borrowing becomes cheaper, increasing spending and investment but potentially causing inflation to rise.

Example:

- In 2022–2023, central banks worldwide, including SARB, the U.S. Federal Reserve, and the European Central Bank, raised interest rates aggressively to combat post-pandemic inflation.

- By early 2024, as inflation pressures started to moderate, some central banks paused rate hikes or began considering rate cuts, affecting currency movements globally.

Impact on Currency Values

Both fiscal and monetary policies **influence exchange rates** by shaping investor confidence and capital flows.

1. **Expansionary policies** (low interest rates, increased government spending) may **weaken a currency** by increasing inflation risks.
2. **Restrictive policies** (high interest rates, reduced spending) may **strengthen a currency** by attracting foreign investment.

Over time, these policies contribute to economic stability and determine whether a country's currency appreciates or depreciates.

Activity:

The Global Financial Crisis of 2008-2009 triggered a massive global recession, the likes of which had not been seen since the Great Depression of the 1930s. As a result, major governments' finances were thrown into disarray, as tax revenues plunged, and spending was maintained or increased through fiscal stimulus. Suddenly the creditworthiness and financial stability of major national governments were being questioned by global markets.

What impact would this have on a country's currency?

Answer:
A currency's perceived value is intrinsically linked to the faith investors have in the financial stability of the nation(s) standing behind it. If investors fear a *sovereign debt default,* meaning government bonds will not be paid back, they are likely to sell both those bonds and the country's currency. The result can be a market frenzy in which government bond prices crash, sending yields soaring and increasing the government's borrowing costs, effectively forcing the government out of global capital markets and leading to a default.

2.1.6 Socioeconomic and Geopolitical Factors

Currency markets are extremely sensitive to socioeconomic and geopolitical developments, as these factors influence investor confidence, capital flows, and macroeconomic stability. Forex traders closely monitor these events, as they can trigger sharp movements in exchange rates.

i. Employment and Currency Strength

Employment is a key indicator of an economy's long-term performance and a primary driver of interest rate decisions.

When employment levels are rising, the economic outlook remains positive, often supporting a country's currency.

However, when job growth declines or unemployment rises, consumer spending and investment slow down, leading to weaker economic growth.

Central banks often cut interest rates in response to rising unemployment to stimulate borrowing and economic activity. These rate cuts can, in turn, weaken the domestic currency.

Example:

In early 2024, a slowdown in the U.S. job market led the Federal Reserve to pause interest rate hikes, affecting the value of the U.S. dollar (USD) against other major currencies.

Similarly, in South Africa, persistently high unemployment rates have contributed to volatility in the South African rand (ZAR), particularly when employment data signals weaker growth prospects.

ii. Deficits and Currency Depreciation

Both fiscal deficits (government overspending) and trade deficits (imports exceeding exports) are typically negative for a currency.

When an economy is weak, deficits amplify risks by increasing a country's reliance on external debt or foreign investment.

When an economy is strong, deficits have less impact but may still weigh on investor confidence.

Example:

In 2023–2024, the United Kingdom's widening fiscal deficit placed pressure on the British pound (GBP) as investors questioned the government's ability to manage debt without triggering inflation.

Similarly, South Africa's persistent trade deficit has made the ZAR vulnerable to capital outflows, particularly when global risk sentiment shifts.

iii. Geopolitical issues and Forex Markets

Geopolitical tensions play an increasingly dominant role in forex markets, as global capital re-allocates in response to uncertainty.

Political instability, wars, sanctions, and trade disputes can drive investors toward safe-haven currencies such as the U.S. dollar (USD), Swiss franc (CHF), and Japanese yen (JPY).

Commodity-linked currencies, such as the Canadian dollar (CAD) and Australian dollar (AUD), may experience price swings if geopolitical risks affect global trade flows or resource demand.

Example:

- The Russia-Ukraine war (2022–present) has significantly impacted emerging market currencies, particularly in Europe. The war contributed to currency depreciation in Eastern European economies, including the Polish zloty (PLN) and Hungarian forint (HUF).
- Oil-exporting nations, such as Saudi Arabia and Russia, experienced currency fluctuations as sanctions and energy supply disruptions affected global crude oil prices.

Further Reading:

Russia-Ukraine war has hit currencies hard. Here is what analysts expect next (cnbc.com)

iv. Political Elections or Uncertainty

Political uncertainty, particularly in major economies, can significantly erode investor confidence and lead to currency depreciation. Forex markets are highly sensitive to political developments, as investors assess how election outcomes and policy changes will impact economic stability and international relations.

- Before elections, markets tend to be cautious, leading to increased volatility as investors position themselves defensively.
- If an election outcome is perceived as negative, the currency may decline sharply, as uncertainty prompts capital outflows toward safer investments.
- Conversely, if the result reassures investors, the currency may recover, but often at a slower pace than it initially declined.

A Key Insight:

Negative political events tend to weaken a currency more than positive political outcomes strengthen it. This is because fear-driven capital flight happens rapidly, whereas confidence-driven investment inflows occur more gradually.

Examples:

The U.S. Presidential Elections and the U.S. Dollar

- In the lead-up to the U.S. presidential elections, the U.S. dollar (USD) often experiences increased volatility as markets assess potential shifts in trade policies, tax regulations, and monetary policy.
- If a candidate with market-friendly policies wins, the USD may recover. However, if uncertainty lingers over policies such as tariffs, corporate taxes, or financial regulations, the dollar could remain under pressure even after the election.

Brexit and the British Pound

- One of the most striking examples of political uncertainty affecting a currency was the 2016 Brexit referendum. In the months leading up to the vote, the British pound (GBP) experienced heightened volatility as traders speculated on the potential impact of the UK leaving the European Union.
- When the referendum results confirmed that the UK would exit the EU, the pound plummeted by more than 10% against the U.S. dollar overnight, marking one of the largest single-day currency declines in history.
- Over the following months and years, GBP remained volatile, as ongoing Brexit negotiations created uncertainty about trade agreements, economic policy, and financial regulations.

South Africa

- In South Africa, ahead of the 2024 general elections, the rand (ZAR) experienced depreciation due to investor concerns over political stability and fiscal policy changes.

v. Economic Policies in Major Economies

The economic policies of major economies—such as the United States, China, the European Union, and Japan—can have far-reaching effects on global markets and currency valuations. These policies influence trade, capital flows, inflation, and monetary policy, often triggering shifts in forex markets worldwide.

Monetary Policy and Currency Markets

Central banks in major economies play a critical role in shaping global exchange rates through interest rate decisions, inflation control, and money supply management.

- The U.S. Federal Reserve (Fed) is particularly influential, as the U.S. dollar (USD) is the world's primary reserve currency. Changes in U.S. interest rates affect global borrowing costs, trade balances, and investment flows.

- The European Central Bank (ECB) sets monetary policy for the euro (EUR), impacting not just the EU but also trade partners and emerging markets with euro-denominated debt.
- The Bank of Japan (BoJ) has historically maintained ultra-low interest rates, influencing demand for the Japanese yen (JPY) as a safe-haven currency.
- The People's Bank of China (PBOC) actively manages the Chinese yuan (CNY), controlling capital flows to maintain economic stability.

Example: U.S. Interest Rate Policy and the USD

- When the Federal Reserve raises interest rates, the USD typically strengthens, as higher yields attract foreign investment.
- When the Fed cuts rates, the USD tends to weaken, as investors seek higher returns elsewhere.
- During periods of uncertainty, investors often favour the USD due to its status as a global safe-haven currency.

Trade Policies and Their Impact on Exchange Rates

Trade policies—including tariffs, sanctions, and trade agreements—affect supply chains, inflation, and currency values.

- The U.S.-China trade war saw tariffs imposed on hundreds of billions of dollars' worth of goods, causing volatility in the Chinese yuan (CNY) and the U.S. dollar (USD).
- Brexit negotiations impacted the British pound (GBP), as uncertainty over trade agreements with the EU led to fluctuations in investor confidence.
- Sanctions on Russia following geopolitical tensions led to the Ruble (RUB) initially depreciating, though capital controls later stabilised its value.

Fiscal Policies and Government Spending

Government spending, taxation, and debt management influence economic growth and currency demand.

- Countries with large fiscal deficits may experience currency depreciation due to concerns over debt sustainability.
- Stimulus measures, such as those implemented in response to economic crises, can weaken a currency if they lead to rising inflation.

Example: Japan's Economic Stimulus and the Yen (JPY)

- Japan has implemented large-scale fiscal stimulus programs to boost economic growth.
- This has kept interest rates low, making the yen a funding currency in carry trades, where investors borrow JPY at low rates to invest in higher-yielding currencies.
- As a result, the yen often depreciates during global economic booms but strengthens in times of uncertainty when investors seek safe-haven assets.

2.2 Risk Appetite Indicators and Exchange Rates

Before delving into risk appetite indicators, it is important to distinguish between risk appetite at the investor level (individual clients and asset managers) and risk appetite at the market level (broader investor sentiment). This section focuses on market-wide risk appetite, which is a key driver of capital flows. The impact of risk appetite on currency valuation is directly proportional to the size of capital flows, making it a significant factor in exchange rate movements.

The Development of Risk Appetite Indicators

Major episodes of cross-market volatility, such as the European Exchange Rate Mechanism (ERM) crisis, the Mexican peso crisis, and the Russian financial crisis, highlighted the need for risk appetite indicators. These indicators were developed to help investors predict potential financial crises or, at the very least, to identify major shifts in investor risk tolerance.
According to Henderson (2006), most risk appetite models classify investor behaviour into three categories:

- **Risk-seeking** – Investors actively pursue higher-yielding and riskier assets.
- **Risk-neutral** – Investors remain balanced between risk-taking and risk-aversion.
- **Risk-averse** – Investors prefer safe-haven assets over riskier investments.

Since most instability indicators focus on market volatility, Henderson (2006) modified these categories into:

- **Stable** – Investors actively seek returns in riskier markets.
- **Neutral** – Investors remain cautious, reducing exposure to risk.
- **Unstable** – Investors move away from risk entirely, preferring safe-haven assets.

Further Reading:

[Measuring Investors' Risk Appetite (europa.eu)](#)

The Fear Index

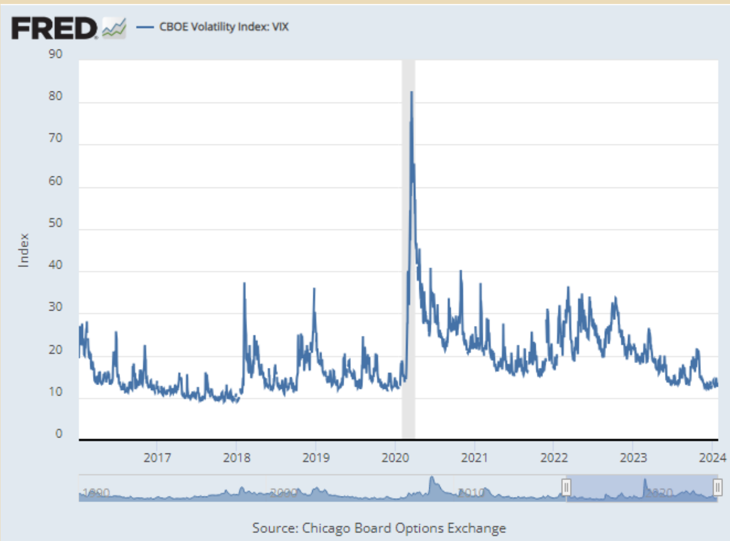
One of the most widely used risk appetite indicators is the Volatility Index (VIX), commonly referred to as the "Fear Index" or "Fear Gauge".

- ✓ The VIX, created by the Chicago Board Options Exchange (CBOE), measures market expectations of volatility over the next 30 days based on S&P 500 options pricing.
- ✓ The higher the VIX, the greater the uncertainty in financial markets, indicating that investors are in a risk-averse mode.
- ✓ The lower the VIX, the calmer the market, suggesting a risk-seeking environment.

South Africa has its own version of the VIX:

- ✓ The South African Volatility Index (SAVI) Top 40 provides a three-month daily prediction of equity market risk in South Africa.
- ✓ The SAVI follows the same principles as the VIX and helps investors assess market sentiment in the South African equity market.

Figure 1: VIX Risk Index



[What Is The VIX Volatility Index? – Forbes Advisor](#)

Figure 2: FTSE/JSE All Share Index

JSE FTSE ALL SHARE INDEX, JALSH:JNB Summary - FT.com

Figure 3: SAVI Risk Index

South Africa Top 40 Index (SA40) - Investing.com ZA

Risk Appetite and Currency Movements

When markets are perceived as stable, investors generally adopt a risk-seeking stance, favouring assets such as:

- Equities and credit products instead of Treasuries or money market investments.
- High-yielding, high-carry currencies instead of low-carry safe-haven currencies (e.g., JPY, CHF).

However, as market conditions deteriorate, investors tend to shift into neutral or risk-averse positions:

- High-carry currencies lose value as investors become more cautious.
- Safe-haven currencies appreciate as capital flows out of riskier assets.

Henderson (2006) established a risk appetite index parameter, categorising market conditions into three risk levels:

- Risk-seeking/stable: VIX <40
- Neutral: VIX 40–50
- Risk-aversion/unstable: VIX >50

Table 1: Currency decision template for risk appetite indicators

Risk Appetite Level	Asset Managers	Currency Speculators	Corporations
Risk-Seeking / Stable (<40)	Increase exposure to high-carry currencies	Increase exposure to high-carry currencies	Increase exposure to high-carry currencies
Neutral (40–50)	Neutral (40–50)	Neutral (40–50)	Neutral (40–50)
Risk-Aversion / Unstable (>50)	Exit high-carry currencies	Short high-carry currencies, buy safe-haven currencies	Hedge only when necessary

Source: Henderson (2006)

When the market is in a "risk-seeking/stable" condition, investors usually buy credit products, and shares/equities as opposed to Treasuries and money market investments and prefer high-carry emerging market currencies to low-carry or safe havens currencies such as the Japanese yen or the Swiss franc. When risk appetite shifts from risk-seeking/ stable to neutral, high-carry currencies generally lose ground as investors become cautious and roll back their exposure.

Generally, low-carry currencies are used as funding currencies to purchase high-carry currencies, therefore, as risk declines, they tend to gain some ground as investors reduce their long high-carry/ short low-carry currency positions. When conditions deteriorate significantly and the market moves into the territory of "risk-aversion/unstable" (above 50), high-carry currencies are dropped across the board in favour of safe haven currencies.

What is Carry Trading?

Carry trading is one of the most popular forex trading strategies. A carry trade occurs when a trader buys a high-interest currency against a low-interest currency. For each day that the trader holds the position, the broker pays the trader the interest rate difference between the two currencies, as long as the broker is trading in the interest-positive direction.

For example, if the British pound (GBP) has a 6% interest rate and the US dollar (USD) has a 3% interest rate, and trade is long the GBP/USD, the trader is making a carry trade and for every day that the position is held, the broker will pay the difference between the 3%

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interest rates differ between the two currencies. Note however that this is not as straightforward as it sounds as there are risks associated with this trading strategy.

To learn more, click on the link: An Introduction to Carry Trading (thebalancemoney.com)

Risk Appetite, Capital Flows, and Currency Performance

Henderson (2006) developed a template for currency trading, drawing from multiple academic and statistical studies that confirm the relationship between currency performance and risk appetite. However, this template is not an exact list of recommendations—instead, it serves as a framework for measuring specific currency exposures on a case-by-case basis. Like all models, there are exceptions, and currency movements do not always follow a predictable pattern.

The link between risk appetite and currencies originates from capital flows, which are reflected in a country's balance of payments.

- Countries with large current account deficits rely heavily on foreign capital inflows to finance their deficits. These economies are more risk-sensitive, meaning that when investor confidence is high (risk-seeking environment), their currencies tend to perform well.
- Countries with current account surpluses do not depend on external capital and are less affected by investor sentiment. As a result, in risk-averse environments, their currencies outperform, as capital outflows from riskier assets drive demand for more stable currencies.

Risk Appetite and Major Currencies

- Currencies of major economies with persistent current account deficits—such as the U.S. dollar (USD) and British pound (GBP)—are considered risk-dependent. Their value is influenced by global capital flows and investor sentiment rather than solely by domestic factors.
- Currencies of surplus-running economies, such as the Japanese yen (JPY) and Swiss franc (CHF), are traditionally considered safe-haven currencies. When market uncertainty rises, investors tend to shift capital into these currencies, increasing their value.
- Notable Exception: The Canadian dollar (CAD) tends to perform well in high-risk environments, despite Canada historically running current account surpluses. This is largely due to its commodity-based economy, which benefits from global demand during risk-seeking periods (Henderson, 2006).

Risk Appetite in Emerging Markets: Key Considerations

While the principles of risk appetite and currency movement apply to both developed and emerging market currencies, there are several additional caveats to consider when using risk appetite or instability indicators for emerging markets:

Most emerging markets have current account deficits, making them highly dependent on foreign capital flows. This makes their currencies vulnerable to risk sentiment shifts. Emerging markets typically experience structurally high inflation, which adds another layer of volatility to their exchange rates.

Interest rates in emerging markets are often unstable due to large and unpredictable capital inflows.

- When capital inflows surge, interest rates are artificially suppressed.
- When inflows reverse, interest rates spike sharply, leading to currency depreciation and financial instability.

Emerging market currencies face additional risks such as political instability, liquidity concerns, and currency convertibility restrictions.

- Political risks remain a primary concern for investors, as governance issues can directly impact currency stability.
- Liquidity constraints in certain emerging markets make it difficult for investors to quickly exit positions without affecting prices.
- Some emerging market currencies are not fully convertible, meaning they have government-imposed restrictions on how easily they can be exchanged for other currencies.

Risk Appetite Indicators as a Benchmark for Currency Risk

Despite these caveats, risk appetite and instability indicators remain valuable tools for trading and managing currency risk, both in developed and emerging markets.
It is crucial to remember that no single model can perfectly predict exchange rate movements. However, understanding risk appetite's role in capital flows allows investors and traders to better anticipate short-term currency movements.

Finally, this approach must be used specifically rather than generally—each investor, trader, or client must tailor their currency risk strategy to their unique exposure and market conditions.

2.3 Measuring Risk-Off and Risk-On Conditions

In addition to using risk appetite indexes, traders assess market sentiment by analysing movements in key asset classes. This process helps provide a quick overview of market conditions and whether investors are in a risk-on or risk-off environment.

This concept is closely linked to Regime Conditions, which Netto et al. (2016) define as:

"The total market environment encapsulating all pertinent fundamental, technical, and sentiment data for a particular asset class." (Netto et al., 2016: p. 57)

Investors can detect shifts in sentiment by monitoring macroeconomic data, corporate earnings, and central bank statements or policy actions.

2.3.1 What is Risk-On Risk-Off?

Risk-on risk-off (RORO) describes how investors adjust their risk tolerance in response to changing market conditions.

- When market risk is perceived as low, investors seek higher-risk assets in pursuit of higher returns (risk-on).
- When market risk is perceived as high, investors shift to lower-risk assets to protect capital (risk-off).

This cycle of risk-taking vs. risk aversion drives capital flows, asset prices, and currency movements.

2.3.2 Understanding Risk-On Risk-Off

Investor risk appetite fluctuates over time, influencing the performance of different asset classes based on prevailing economic conditions. Shifts between risk-on and risk-off environments determine where investors allocate capital, affecting market trends and currency values.

Example: The COVID-19 Market Crash as a Risk-Off Period

The COVID-19 pandemic in early 2020 caused a sharp global market selloff, leading to a major risk-off event:

- Stock markets plummeted, with the S&P 500 falling by more than 30% in March 2020.
- Investors liquidated risky assets, such as equities and emerging market currencies.
- Capital flowed into safe-haven assets, particularly U.S. Treasury bonds, gold, and the Japanese yen (JPY).
- Central banks, including the U.S. Federal Reserve, responded by cutting interest rates and introducing large-scale stimulus programs to stabilize markets.

This period demonstrated how global crises can quickly shift market sentiment, causing investors to seek safety over returns, significantly affecting currency values and asset prices.

Characteristics of Risk-On Markets

Risk-on periods occur when market confidence is high, often driven by:

- ✓ Positive economic growth
- ✓ Accommodative central bank policies (low interest rates)
- ✓ Strong corporate earnings
- ✓ Stock market gains & speculation

During these times, investors increase exposure to riskier assets, leading to a bullish market outlook.

- ✓ Characteristics of Risk-Off Markets
- ✓ Risk-off environments occur when market uncertainty increases, often triggered by:
- ✓ Economic slowdowns
- ✓ Weak corporate earnings
- ✓ Stock market declines
- ✓ Geopolitical tensions

During these periods, investors shift capital into safe-haven assets, adopting a bearish market outlook.

2.3.3 Risk-On Risk-Off and the Performance of Different Asset Classes

Different asset classes exhibit varying degrees of risk, meaning their performance is directly impacted by shifts between risk-on and risk-off environments.

Assets that Perform Well in Risk-On Environments:

During risk-on periods, investors seek higher returns and allocate capital toward:

- ✓ Shares with high price-to-earnings (P/E) ratios
- ✓ High-yield bonds
- ✓ High-yield (carry trade) currencies
- ✓ Emerging market stocks & indexes
- ✓ Industrial metals (copper, aluminium, etc.)
- ✓ Crude oil & energy shares

Assets that Perform Well in Risk-Off Environments:

During risk-off periods, investors shift capital toward low-risk and safe-haven assets:

- ✓ Gold (historically a safe-haven store of value)
- ✓ Money market funds (low volatility investments)

- ✓ Government bonds (U.S. Treasuries, German Bunds, etc.)
- ✓ AAA-rated corporate bonds (low default risk)
- ✓ Low-interest-rate currencies (e.g., JPY, CHF)
- ✓ Defensive stocks (utilities, consumer staples, healthcare)

2.4 Identifying Shifts in Investor Sentiment

Certain trends in the market can give cues to the direction of investor sentiments as the different types of asset classes rise or fall depending on the direction of the shift in investor confidence.

Table 2 shows the basic relationship of markets and risk-on/risk-off conditions.

Table 2: Markets and risk-on/ risk-off conditions

Underlying Asset	Direction in Risk-On Markets	Direction in Risk-Off Market
US dollar	Strengthens	Weakens
VIX	Falling	Rising
Yen/Dollar (JPY/USD)	Strengthens	Weakens
Gold	Weakens	Strengthens
Bond Yields	Falling	Rising
Crude Oil	Strengthens	Weakens

Source: Rivero (2020)

Traders can look out for the following to determine whether sentiments are beginning to shift:

a) Dramatic rise in gold prices

Investors consider gold to be a safe haven investment, therefore, once the economic outlook turns negative, they start shifting to safe-haven assets which will result in the price of gold rising, which indicates a flight to safety.

b) The VIX

This is volatility index is also called the "fear index." A rising VIX indicates that overall sentiments are turning bearish.

c) Bond yields decrease

During bullish periods, there is increasing demand for the different asset classes. As demand for bonds increases, their prices increase, and their yields decrease. There is a negative relationship between bond prices and yields, therefore, as investor confidence declines, they start selling their investments to move to safe haven investments. As the price of bonds declines, their yields move up therefore declining prices and increasing yields could be an indicator that market sentiments are switching from bullish to bearish.

d) High-low stock market index

Dramatic changes in stock market indexes could indicate a shift in investor sentiments.

e) Put/ call ratio

When investors believe that prices will increase, they buy calls in the derivatives market, and when they believe that prices will go down, they buy puts. Therefore, when the volume of calls is higher than the volume of puts, this indicates an increasing market optimism. The higher the ratio, the higher the optimism.

Unit 2 Summary

The forex market was once dominated by hedge funds, global banks, multinational corporations, and high-net-worth investors. However, this changed with the technological revolution of online trading, making the forex market more accessible than ever before.

Today, individual traders and investors worldwide participate in forex trading, drawn by its liquidity, volatility, and around-the-clock opportunities. The rise of internet-based trading platforms has democratized access to the forex market, allowing retail traders to engage in currency speculation alongside institutional players.

Forex markets are among the fastest moving and most volatile financial markets. Prices can shift within minutes or even seconds, presenting both opportunities and risks. At the same time, currencies can exhibit long-term trends, lasting from several days to weeks or even years. This constant movement provides a dynamic and target-rich trading environment for investors.

<u>The Role of Information in Forex Markets</u>

Information is the driving force behind every financial market, and forex is no exception. Multiple economic and geopolitical factors influence currency prices at any given moment, including:

- Financial crises
- Central bank interest rate decisions
- Economic growth data
- Trade and geopolitical events

<u>Economic Fundamentals in the Forex Market</u>

The term fundamentals refer to the broader economic and political factors that shape the value of a currency. These fundamentals provide insight into a country's economic health and financial stability, influencing currency demand and supply.
Key economic fundamentals include:

- ✓ Economic cycles and data reports – Measuring growth and contraction trends in an economy.
- ✓ Interest rate levels – The cost of borrowing, which directly affects currency value.
- ✓ Monetary policy – Central bank actions, such as adjusting interest rates and money supply.
- ✓ Inflation – The rate at which prices rise, affecting purchasing power.
- ✓ International trade flows – The movement of goods and services between countries.
- ✓ International investment flows – Cross-border capital movements, including foreign direct investment (FDI) and portfolio investments.
- ✓ Political and geopolitical factors – Elections, trade policies, sanctions, and conflicts that influence investor confidence.

Unit 3: The Legislative Environment in Relation to Foreign Currency Trading

The Global Code of Foreign Exchange → **The FAIS Code of Conduct for Authorised FSP and Rep involved in Foreign Exchange** → **The Exchange Control Regulations**

3.1 The Global Code on Foreign Exchange

The Code is a set of global principles of good practice in the foreign exchange market, which has been developed to provide a common set of guidelines to promote the integrity and functioning of the market. It is intended to promote a robust, fair, liquid, open and transparent market, in which a diverse set of market participants can confidently and effectively transact at competitive prices that reflect available market information, and in a manner that conforms to acceptable standards of behaviour.

The Code does not impose legal obligations on market participants and is intended to serve as a supplement to applicable local laws.

A market participant is defined as a person or organisation that:

i) is active in FX markets as a regular part of its business and is engaged in the activity of the purchase or sale of one currency against another, or in transactions designed to result in gains or losses based upon the change in one or more FX rates.
ii) operates a facility, system, platform or organisation through which participants have the ability to execute the type of transactions described in (i) above.
iii) provides FX benchmarks execution services.
iv) is not considered a retail market participant in its jurisdiction of operation.

Take Note

Examples of market participants include financial institutions, stockbrokers, asset managers, central banks, and e-trading platforms.

Activity:

BNF Bank is an authorised financial services provider. The bank offers foreign currency accounts to businesses for the settlement of import arrangements. Will BNF Bank be required to comply with the Global Code?

Answer:
Yes. BNF Bank is deemed to be a market participant and, hence, will need to comply with the Global Code.

The Global Code is organised around six leading principles:

1. **Ethics**

Market participants are expected to act ethically and professionally to maintain the fairness, transparency, and integrity of the forex market. Ethical conduct is essential because the FX market operates on trust and confidence—any manipulation, fraud, or unfair practices can distort exchange rates, harm investors, and undermine market stability.

By adhering to ethical standards, traders and institutions help ensure a level playing field, where all participants have equal access to information and no unfair advantages. Ethical behaviour also protects market credibility, reducing the risk of scandals or regulatory crackdowns that could damage investor trust. Additionally, it helps minimize systemic risk, as unethical practices—such as price manipulation, insider trading, or false reporting—can lead to severe market disruptions and financial instability.

Ultimately, ethical behaviour reinforces investor confidence, which is crucial in a decentralized and highly liquid market like forex. A well-regulated and transparent FX market benefits all participants by ensuring fair pricing and market efficiency.

2. Governance

Market participants are expected to have a sound and effective governance framework, to provide for clear responsibility and oversight of their activity in the market and to promote responsible engagement in the FX market.

3. Execution

Market participants are expected to exercise care when negotiating or executing transactions to promote a robust, fair and open FX market.

4. Information Sharing

Market participants are expected to be clear and accurate in their communications and to protect confidential information to promote effective communication that supports a robust, fair and open FX market.

5. Risk Management and Compliance

Market participants are expected to promote and maintain a robust control and compliance environment to effectively identify, manage and report on the risks associated with their engagement in the FX market.

6. Confirmation and Settlement Processes

Market participants are expected to put in place robust, transparent and efficient risk-mitigating post-trade processes to promote the predictable, smooth and timely settlement of transactions in the FX market.

3.2 The FAIS Code of Conduct for Authorised Financial Services Providers and their Representatives Involved in Forex Investment Business

The Code applies to forex service providers who are defined as authorised financial services providers carrying on business as a forex investment advisor or a forex investment intermediary (including any representative of any such advisor or intermediary).

Take Note

Forex investment advisor means an authorised financial services provider carrying on, as a regular feature of business, the rendering of advice on forex investments.

The Code is made up of three components as illustrated in the diagram below. Each of these components will be discussed in greater detail in the sections that follow.

General prohibition and duties for forex investment intermediaries → Special provisions applying to forex investment intermediaries → Special provisions applying to forex investment advisors

3.2.1 General Prohibition and duties for Forex Investment Intermediaries

General Prohibitions

A forex investment intermediary may not, whether directly or indirectly –

- Induce a client to enter into a mandate or any other agreement relating to forex investments.
- Sell client details to a third party without the client's consent.
- Charge a client a fee for terminating a mandate unless such fees were accrued for services rendered prior to termination.
- Deal with client funds that have not been cleared under exchange control laws.
- Churn a client's account for fees and commission.
- In promoting or advertising forex investments –
  - Quote hypothetical returns.
  - Quote real investment returns for a period shorter than 12 months.
  - State or imply that the investment performance of the intermediary or product achieved in the past will be repeated.

General Duties

A forex investment intermediary must –

- Deposit or transfer funds received from a client, without delay, to the final destination agreed with the client, in terms of the mandate with the client.
- If performing the role of an introducing broker of a forex services provider, disclose such fact to the client, and assure the client that funds received will, at all times, be separated from its own funds.
- Observe high standards of integrity and fair dealing in all matters.
- Act in the interest of the client.
- Act with due skill, care and diligence.
- Observe high standards of market conduct.
- Provide to a client, on request, any reasonable information, market practices and risks regarding the investment made by the client.

- Obtain from the client necessary information about their financial situation, investment experience and objectives, to enable the intermediary to act in the interests of the client.
- Avoid any conflict between own interest and the interests of the client. Where such interest cannot be avoided, it must be disclosed to the client, or the intermediary must decline to act for that client.
- Ensure that all staff and representatives are trained on the FAIS Act.
- Notify the Registrar, in writing, if it is to cease conducting business or if its business is to be wound up or liquidated.

The forex investment provider must disclose the following information to the client:

- Fees and charges relating to services rendered.
- Non-cash incentives offered, or other consideration payable by another provider or supplier as a result of intermediating investments of the client.
- How fees and charges are calculated and charged.
- Name and address of the foreign forex services provider or clearing firm used.
- Name and address of the foreign regulator of the foreign forex services provider or clearing firm.
- Name and address of the foreign regulator under whose jurisdiction the dealing activity falls.
- Whether the foreign forex services provider or clearing firm maintains insurance cover to cover against fraud, dishonesty and negligence by such provider or firm, as well as the extent of such cover.

3.2.2 Special Provisions Applying to Forex Investment Intermediaries

- A forex investment intermediary must enter into a written mandate with the client, irrespective of whether the client invests in a managed or self-directed forex account. An electronic mandate may be entered into, provided that appropriate controls and personal identification procedures have been put in place. The mandate must comply with the requirements prescribed in the code.
- The forex investment intermediary must furnish a written report to the client, on request; or, in the case of managed accounts, on a monthly basis. The content of the report is prescribed in terms of the Code.
- A forex services provider must maintain suitable guarantees or professional insurance or fidelity insurance.

3.2.3 Special Provisions Applying to Forex Investment Advisors

- A forex investment advisor must, prior to referring clients to a forex intermediary, ascertain whether the intermediary is an authorised financial services provider.

- A forex investment advisor must conduct its business with a representative in the same manner as it would with an intermediary.
- The advisor must commence its business relationship with a client by way of a written application form signed by the client and, where applicable, the intermediary.
- The application form must record the arrangements between the parties and must disclose the requirements prescribed in terms of the Code.
- The Registrar must approve the application form. Consent must be sought from the Registrar for all subsequent amendments.
- The forex investment advisor must enter into a written agreement with each intermediary to whom it refers clients. The agreement must record their particular arrangements and make provisions for the termination of the agreement.

Record of Advice

- The forex investment advisor must maintain a record of any advice furnished to a client.
- The record must reflect the basis on which the advice was given.
- The record of advice must be made available to the client, in writing.

Activity:

"Hedge Brokers" is an authorised financial services provider that renders advice to clients on forex-related investments.

Is "Hedge Brokers" performing the role of a forex investment advisor or a forex investment intermediary?

Answer:
Hedge Brokers provides advice on forex-related investments and is thus performing the role of an advisor.

3.3 The Exchange Control Regulations

3.3.1 Overview

In terms of the exchange control regulations, every transaction in which:

- a South African natural or juristic person transacts with a non-South African party; and
- in terms of which transactions or funds flow out or are likely to flow out of South Africa,

is subject to exchange control regulations.

In terms of the regulation, no South African resident may transact in foreign exchange except with the approval of and subject to the conditions set by South Africa's National Treasury. The objective of exchange control is thus to control the flow of capital into and out of South Africa; and, generally, to limit the export of capital by residents.

Take Note

For the purposes of exchange control, a South African resident is defined as "any person (i.e. natural person or a legal entity) whether of South African or any other nationality who has taken up permanent residence, is domiciled or registered in the Republic."

The administration of exchange control in South Africa has been delegated to the South African Reserve Bank (SARB) and administratively performed by the Financial Surveillance Department of the SARB. Certain powers, set out in the Exchange Control Rulings, have been delegated to authorised dealers (for instance banks licensed to deal in foreign exchange).

The consequence of a failure by a South African resident to comply with exchange control is that such a resident commits a criminal offence, punishable by fine or imprisonment or, in certain instances, both a fine and imprisonment.

3.3.2 Regulations of General Application

In terms of Regulation 6 exchange control, residents who export services and/or goods and become entitled to receive payment in a foreign currency are obliged, within 30 days of the funds becoming available, to offer for sale to an authorised dealer (bank), the foreign currency proceeds. An exception to this requirement is via the operation of a Customer Foreign Currency Account. Therefore, foreign currency earnings are required to be repatriated within 30 days of accrual, unless the Customer Foreign Currency Account facility is used.

Corporate entities actively engaged in import and export transactions, and providers of services to non-residents are permitted, subject to prescribed conditions, to maintain Customer Foreign Currency Accounts with authorised dealers to offset import costs against export proceeds or handle foreign currency transactions directly related to the business of the local entity.

3.3.3 Obtaining Exchange Control Approval

An application for exchange control approval is almost always made through an authorised dealer. Most large commercial banks are authorised dealers. Only an authorised dealer may deal with the SARB to obtain exchange control approval.

The authorised dealer submits the exchange control application and liaises with the SARB in respect thereof. It usually takes four to eight weeks to obtain approval in respect of a transaction and, depending on the transaction involved, approval may be subject to certain conditions or timeframes.

Transactions in respect of which applications must be submitted for exchange control approval include, but are not limited to:

- Loan agreements (whether interest-bearing or not), in terms of which a South African company borrows money from a foreign entity (because the South African company will have to repay the loan to the foreign entity, i.e. to an entity outside of South Africa).
- A transaction in which a foreign company sells to a local company its shares in a South African company (because the local company will have to make payment for the shares to an offshore bank account).
- A license agreement between an offshore company and a South African company (for example, for the use of the offshore company's intellectual property by the local company, because the South African company will have to pay royalties to the foreign entity).
- A management agreement in terms of which management fees are payable by a local company to an offshore entity.
- Subscription by a foreign company for shares in a South African unlisted company, which may take place without prior exchange control approval; but the certificates must be presented to an authorised dealer for non-resident endorsement.

3.3.4 The Currency and Exchanges Guidelines in Relation to South African Residents

The Currency and Exchanges Guidelines are issued by the SARB to assist individuals by providing a general understanding of the exchange control system in South Africa. The guidelines do not have any statutory force, nor do they supersede the Exchange Control Regulations.

In this section, we will look at the foreign exchange restrictions and dispensations on South African resident individuals. In terms of the guidelines, South African resident individuals are permitted to conduct a foreign currency account with an authorised dealer (such as a bank) for the following purposes:

- travel

- investment
- legitimate foreign earned income
- foreign inheritance

a) Single Discretionary Allowance

The Single Discretionary Allowance (SDA) permits South African residents aged 18 and older to transfer up to R1 million per calendar year abroad for any legal purpose, including investments, gifts, and travel expenses. Utilizing the SDA does not require prior tax clearance from the South African Revenue Service (SARS); however, when the allowance is used for travel outside the Common Monetary Area (CMA)—comprising Eswatini, Lesotho, Namibia, and South Africa—individuals must present a valid passenger ticket to the authorised dealer. Additionally, a valid South African identity document is required for all SDA transactions.

It's important to note that the SDA is available exclusively to South African residents. Individuals who have ceased their tax residency are granted a once-off travel allowance of up to R1 million in the calendar year they change their tax status, which cannot be used in subsequent years.

For transfers exceeding the R1 million SDA limit, residents can utilize the Foreign Investment Allowance (FIA), which allows for an additional transfer of up to R10 million per calendar year, subject to obtaining a Tax Compliance Status (TCS) PIN from SARS. Transfers beyond this combined R11 million thresholds require special approval from the South African Reserve Bank (SARB) and are subject to more stringent compliance checks.

Residents should also be aware that international credit card transactions count toward the SDA limit. Therefore, it's essential to monitor all foreign expenditures to avoid inadvertently exceeding the annual allowance.

In summary, the SDA offers South African residents a flexible means to transfer funds abroad for various purposes within the R1 million annual limit, while the FIA provides an avenue for larger investments, both governed by specific regulatory requirements to ensure compliance with national financial regulations.

b) Annual Foreign Investment Allowance

The Annual Foreign Investment Allowance (FIA) permits South African residents aged 18 and older to transfer up to R10 million per calendar year abroad for investment purposes. To utilize this allowance, individuals must obtain a Tax Compliance Status (TCS) PIN from the South African Revenue Service (SARS), confirming their tax affairs are in order. This TCS PIN replaces the previously issued Tax Clearance Certificate and is a prerequisite for transferring funds under the FIA. Once obtained, the TCS PIN is valid for a period of 12 months, allowing multiple transactions within the approved limit during that timeframe.

Funds transferred under the FIA can be invested in various offshore assets, including foreign bank accounts, investment portfolios, and real estate. It's important to note that while the initial transfer requires tax clearance, subsequent growth or returns on these investments do not necessitate further approvals. However, any additional capital transfers beyond the annual R10 million limits would require a new TCS PIN and adherence to the same application process.

For individuals seeking to transfer amounts exceeding the combined R11 million annual limit (R1 million SDA plus R10 million FIA), special application to the South African Reserve Bank (SARB) is required. These applications are subject to more stringent scrutiny and must demonstrate a legitimate purpose for the additional offshore investment. It's advisable to consult with financial professionals to navigate this process effectively.

In summary, the FIA provides South African residents with a structured mechanism to diversify their investment portfolios internationally, subject to compliance with tax and exchange control regulations. Proper adherence to these requirements ensures seamless integration into the global financial landscape.

c) Krugerrand Coins

In addition to the Single Discretionary Allowance, South African residents are permitted to export Krugerrand coins or equivalent fractional Krugerrand coins up to a value of R30,000 as gifts to non-residents. This export is contingent upon completing the prescribed SARS Customs Declaration. It's important to note that this allowance is separate from the Single Discretionary Allowance and specifically pertains to gifting Krugerrand coins to non-residents.

For non-resident visitors, the regulations differ slightly. They are allowed to export up to 15 Krugerrand coins or the equivalent in fractional Krugerrand coins. This export must be supported by the prescribed SARS Customs Declaration, and visitors must provide proof that the coins were purchased using foreign currency brought into South Africa.

Adherence to these regulations ensures compliance with South African exchange control policies and facilitates the lawful gifting and transport of Krugerrand coins across borders.

d) Travel Allowance

South African residents planning to travel abroad can utilize their Single Discretionary Allowance (SDA) as a travel allowance, subject to specific conditions:

- Age Restrictions: Individuals under 18 years are not eligible for the full R1 million SDA. Instead, they are permitted a travel allowance of up to R200,000 per calendar year.

- Timing of Purchase: Foreign currency for travel purposes may be purchased no earlier than 60 days prior to departure. Travellers must present a valid passenger ticket when obtaining foreign currency from an authorized dealer.
- Use of Bank Cards: Travelers can use bank credit or debit cards to access up to 100% of their remaining SDA for foreign currency transactions while abroad.
- Carrying Cash: For trips outside the Common Monetary Area (CMA), individuals are allowed to carry up to R25,000 in South African rand notes in addition to their travel allowance. Amounts exceeding this require prior authorization from the South African Reserve Bank (SARB).
- Unused Foreign Currency: Any unused foreign currency must be resold to an authorized dealer within 30 days of returning to South Africa. However, for frequent business travellers with a subsequent trip commencing within 90 days of return, retaining the foreign currency for the next trip is permissible.

Adherence to these regulations ensures compliance with South African exchange control policies and facilitates smooth financial transactions during international travel.

e) Study Allowance

Individuals proceeding abroad for study purposes may avail of the R1 million single discretionary allowance. Spouses accompanying students also qualify for the facility.

Students may export household or personal effects, including jewellery, but excluding motor vehicles, up to the value of R200 000 per student. Authorised dealers may transfer directly to the institution concerned, the relevant tuition and academic fees.

Students under the age of 18 also qualify for a study allowance to pay for costs associated with their studies abroad, as well as a travel allowance of R200 000 per calendar year.

f) Import Payments

The single discretionary allowance may not be utilised for import payments. Individuals may utilise debit or credit cards to make foreign currency payments, but subject to a limit of R50 000 per transaction. Transactions may not be split into smaller amounts in an attempt to circumvent this dispensation.

Individuals may purchase foreign currency for payment of imports via an authorised dealer. Payments for imports will require documentary evidence to be produced.

Unit 3 Summary

The Global Code on Foreign Exchange is a set of internationally recognized principles designed to promote good practice, integrity, and transparency in the foreign exchange (FX) market. The Code provides a common framework to ensure that market participants operate in a robust, fair, liquid, open, and transparent manner. By adhering to these principles, a diverse range of participants—including banks, corporations, asset managers, and traders—can confidently and effectively transact at competitive market-driven prices, while maintaining standards of ethical and professional conduct.

The Financial Advisory and Intermediary Services (FAIS) Specific Code applies to authorised forex service providers, which include forex investment advisors and intermediaries. The Code outlines three key areas of compliance:

1. General prohibitions and duties applicable to all forex investment intermediaries.
2. Special provisions for forex investment intermediaries regulating how they conduct business.
3. Special provisions for forex investment advisors, ensuring professional conduct and financial integrity.

This framework ensures that financial service providers in the forex industry operate ethically, transparently, and in the best interests of their clients.
Exchange Control Regulations

South Africa enforces exchange control regulations to monitor and regulate the movement of capital in and out of the country. These regulations apply to any transaction where:

- A South African natural or juristic person transacts with a non-South African party.
- The transaction results in or is likely to result in a flow of funds out of South Africa.

Under these rules, South African residents cannot transact in foreign exchange unless they receive approval from South Africa's National Treasury and comply with conditions set by the South African Reserve Bank (SARB). The primary objectives of exchange control are:

- Managing capital flows to maintain economic stability.
- Preventing excessive capital outflows, which could weaken the South African economy.

The Currency and Exchanges Guidelines, issued by the SARB, serve as an informational resource to help individuals understand South Africa's exchange control system. These guidelines, however, do not have statutory force and do not override the legally binding

Exchange Control Regulations. Instead, they provide practical guidance on how exchange control regulations are applied.

South African residents are permitted to hold foreign currency accounts with an authorised dealer (e.g., a bank) for specific purposes, including:

- Travel-related expenses
- Foreign investments
- Legitimate foreign-earned income
- Foreign inheritances

These allowances enable South African individuals to engage in cross-border financial transactions, while ensuring compliance with exchange control regulations.

Unit 4: Foreign Exchange Products

Client Needs in Relation to Foreign Currency Products → **Foreign Currency Products** → **Forex Alternatives**

This unit provides an overview of the generic foreign exchange products offered by authorised dealers. It explores the general characteristics, terms and features, typical fee structures and tax implications of these products. In addition, it describes the appropriateness of these products for specific client needs.

Authorised dealers may structure their own products – subject to legislative requirements – to give them a competitive advantage. Learners are required to understand the products that they are authorised to provide advice or render an intermediary service on.

4.1 Client Needs in Relation to Foreign Currency Products

Clients may have different reasons for wanting to transact in foreign currency. The type of foreign currency product that is offered would depend on the client's preferences and circumstances. When rendering advice to clients on the suitability of a product, the representative is required to obtain certain information from the client in order to assist the representative in understanding the client's needs and circumstances. This process is known as a financial needs analysis.

Some of the client's needs in relation to foreign currency products include:

- A safe and secure way of sending money abroad
- An efficient and safe way of receiving money from abroad
- Foreign currency notes or travel cards
- Foreign exchange investments

- Import and export purposes

4.2 Foreign Currency Products

Authorised Dealers offer a range of foreign exchange solutions to suit client needs – whether they are travelling, sending or receiving money globally, saving in a foreign currency, managing imports and exports, or investing offshore. Forex is a simple and convenient way to transact around the world.

4.2.1 Global Payment Facility

Description	These solutions make the process of sending money abroad simple, secure and convenient so that clients can transact and manage their global payments.
Product Features	• Authorised dealers make use of the SWIFT method of transferring funds. • Personalised exchange rates. • Competitive fees. • Payments are securely processed, typically via online banking platforms.
Benefits	Safe and secure way of transferring money abroad.
Product Rules	• Clients are required to provide all identification and proof of address documents, as required by FICA. • Authorised dealers may require a qualifying account, such as a cheque account, to facilitate the payment. • Clients must be satisfied that the product meets their specific needs, and that fees and charges are affordable, particularly in instances where sales consultants are not authorised to provide advice.
Term	The account can remain active for as long as the client desires.
Fees/ Pricing	All exchange rates are updated regularly. These rates are indicative and exclude commissions and charges which differ from bank to bank. Rates may differ due to changing market conditions and the amount of the transaction.
Tax Implications	Depending on the nature of the transaction, there may be tax implications applicable to the sender. These may include but are not limited to income tax, donations tax, customs duty and dividend withholding tax.
Risk	Low risk.
Suitability to investor	Suitable to clients who need to make global payments safely and securely.

4.2.2 Global Receipts Facility

Description	These accounts make the process of receiving money from abroad simple and secure.
Product Features	• Authorised dealers make use of the SWIFT method of receiving funds. • Each authorised dealer will have their own SWIFT Code. • Recipients have 30 days to convert the funds into rands before it is sent back to the originator. • Funds are converted at competitive rates and are based on the prevailing exchange rate.
Benefits	• Safe and secure way of receiving money abroad. • Funds can be converted into rands usually within 7-30 days.
Product Rules	• Clients are required to provide all identification and proof of address documents as required by FICA. • Authorised dealers may require a qualifying account, such as a cheque account, to receive the payment. • Clients must be satisfied that the product meets their specific needs, and that fees and charges are affordable, particularly in instances where sales consultants are not authorised to provide advice.
Term	The service is available to clients on demand.
Fees/ Pricing	All exchange rates are updated regularly. These rates are indicative and exclude commissions and charges which differ from bank to bank. Rates may differ due to changing market conditions and the amount of the transaction.
Tax Implications	Depending on the nature of the transaction, there may be tax implications applicable to the recipient. These may include but are not limited to: income tax, donations tax, customs duty, capital gains tax and dividend withholding tax.
Risk	Low risk.
Suitability to investor	Suitable to clients who need to receive global payments in a safe and secure manner.

4.2.3 MoneyGram

Description	MoneyGram is a safe, easy and fast way for you to send money to friends and family around the world; without them needing a bank account.
Product Features	• With MoneyGram, money can be sent from any branch, or ATM. • The money can be collected by the beneficiary in the preferred currency of that particular country, within minutes of sending it.
Benefits	• Simple process from sender to receiver. • Accessible: Encashment available at more than 350 000 MoneyGram outlet locations in 200 countries and territories worldwide. • Affordable: It's an affordable way to send money abroad. • Helpful: A short message can be a part of the transaction. • Reliable: The sender can rest assured that the money will reach the destination. • Secure: Complies with international money transfer regulations.
Product Rules	• Clients are required to provide all identification and proof of address documents, as required by FICA. • Authorised dealers may require a qualifying account, such as a cheque account, to receive the payment. • Clients must be satisfied that the product meets their specific needs, and that fees and charges are affordable, particularly in instances where sales consultants are not authorised to provide advice.
Term	The service is available to clients on demand.
Fees/ Pricing	All exchange rates are updated regularly. These rates are indicative and exclude commissions and charges which differ from bank to bank. Rates may differ due to changing market conditions and the amount of the transaction.
Tax Implications	Depending on the nature of the transaction, there may be tax implications applicable to the sender. These may include but are not limited to: income tax, donations tax, customs duty and dividend withholding tax.
Risk	Low risk.
Suitability to investor	Suitable to clients who need to send money abroad in a safe and secure manner.

4.2.4 PayPal

Description	PayPal is a safe, easy way to send, spend and manage money.
Product Features	• The payment can be facilitated via online platforms. • The user signs up for a PayPal account and loads all relevant credit cards. When purchases are made, the card details are readily available and pre-populated.
Benefits	• Simple sign-up process. • Payments can be made faster and securely.
Product Rules	• Clients are required to sign-up for PayPal by creating an online account. • The user is required to have a valid credit card.
Term	The service is available to clients on demand.
Fees/ Pricing	Commercial payment fees and other additional fees may be levied.
Tax Implications	Depending on the nature of the transaction, there may be tax implications applicable to the sender. These may include but are not limited to, income tax, donations tax, customs duty and dividend withholding tax.
Risk	Low risk.
Suitability to investor	Suitable to clients who need to send money abroad or purchase items from abroad.

4.2.5 Foreign Notes

Description	Cash in the currency needed by the client.
Product Features	• Order various currencies in cash and select the denominations needed. • All major currencies and other currencies can be ordered on request.
Benefits	• Simple process that can be facilitated online or via a branch network. • The most accepted form of payment.
Product Rules	• Clients are required to provide all identification and proof of address documents, as required by FICA. • Authorised dealers may require a qualifying account, such as a cheque account, to receive the payment. • Clients must be satisfied that the product meets their specific needs, and that fees and charges are affordable, particularly in instances where sales consultants are not authorised to provide advice. • Foreign currency for travel purposes may not be bought more than 60 days prior to your departure.
Term	The service is available to clients on demand.
Fees/ Pricing	All exchange rates are updated regularly. These rates are indicative and exclude commissions and charges which differ from bank to bank. Rates

	may differ due to changing market conditions and the amount of the transaction.
Tax Implications	There may be tax implications if the foreign notes are used for trading purposes.
Risk	Low risk.
Suitability to investor	Suitable to clients who are travelling abroad and require cash on hand.

4.2.6 Travel Card

Description	A prepaid card that is used to pay for goods and withdraw cash around the world.
Product Features	• Order various currencies in cash and select the denominations needed. • Order and load the travel card in any of the four major currencies available on the card: US dollars, Australian dollars, euros or pounds. • Top up funds by reloading the card before travelling and whilst travelling. • Chip and PIN enabled. • Lock-in rate to avoid exchange-rate fluctuations. • Check balances, view transactions and move money between currencies using the travel card.
Benefits	• Simple process that can be facilitated online or via a branch network. • It can be uploaded with up to 4 major currencies. • Card can remain valid for up to 5 years.
Product Rules	• Clients are required to provide all identification and proof of address documents, as required by FICA. • Authorised dealers may require a qualifying account, such as a cheque account. • Clients must be satisfied that the product meets their specific needs, and that fees and charges are affordable, particularly in instances where sales consultants are not authorised to provide advice. • Foreign currency for travel purposes may not be bought more than 60 days prior to your departure. • Interest is usually not earned on balances in the card.
Term	The service is available to clients on demand.
Fees/ Pricing	All exchange rates are updated regularly. These rates are indicative and exclude commissions and charges which differ from bank to bank. Rates may differ due to changing market conditions and the amount of the transaction.

Tax Implications	Might attract that country's equivalent value-added tax for foreign purchases when using the card.
Risk	Low risk.
Suitability to investor	Suitable to clients who are travelling abroad and require money on demand.

4.2.7 Forex Investment Options

Description	A service that streamlines the process for South African residents to invest funds abroad, utilizing authorized allowances and adhering to current regulatory requirements.
Product Features	• Investment Allowances: South African residents aged 18 and older may invest offshore using: • Single Discretionary Allowance (SDA): Up to R1 million per calendar year without prior tax clearance. • Foreign Investment Allowance (FIA): Up to an additional R10 million per calendar year, requiring an Approval International Transfer (AIT) PIN from the South African Revenue Service (SARS). • Convenient Transfers: Facilitate your international transfers online at any time. • Secure Processing: Payments are processed electronically via the SWIFT network, ensuring funds reach their destination safely and securely. • Hedging Solutions: Access to hedging options to protect against exchange rate fluctuations.
Benefits	A simplified process that can be managed online or through a branch network, providing flexibility and ease of use.
Product Rules	• Documentation: Clients must provide valid identification and proof of address as required by the Financial Intelligence Centre Act (FICA). • Qualifying Accounts: Authorized dealers may require a qualifying account, such as a cheque account, to facilitate transactions. • Client Responsibility: Clients should ensure the product aligns with their investment objectives and that they understand all associated fees and charges, especially when sales consultants are not authorized to provide personalized advice. • Eligibility: Clients must be over 18 years old and registered taxpayers in South Africa.
Term	The service is available to clients on demand, subject to compliance with regulatory requirements.

Fees/ Pricing	All exchange rates are updated regularly. These rates are indicative and exclude commissions and charges which differ from bank to bank. Rates may differ due to changing market conditions and the amount of the transaction
Tax Implications	There may be tax implications applicable to the investor. These may include but are not limited to income tax, donations tax, customs duty, capital gains tax and dividend withholding tax. Depending on the jurisdiction, tax clearance may be required to place investments offshore.
Risk	Low risk.
Suitability to investor	Ideal for clients seeking to diversify their portfolios by investing offshore, who have a clear understanding of the associated risks and regulatory requirements.

4.2.8 Letters of Credit (LC)

Description	A Documentary Credit (DC) is a written undertaking by a bank at the request of an importer/ buyer, in favour of an exporter/ seller, whereby the bank agrees to pay against bills of exchange and/ or documents that comply with the terms and conditions of the documentary credit. 'Documentary Credit' is also known as 'Letters of Credit' (LC).
Product Features	A letter of credit can be used to guarantee payment to the exporter, whilst simultaneously assuring the importer that payment will not take place until the exporter has shipped the goods.
Benefits	• A convenient way for the importer to know that goods have been shipped before payment will be made. • The exporter is relieved of the administrative burden of collecting the proceeds, handling correspondence and any follow-up action that needs to take place. The importer is given the opportunity to prove to the exporter that payment will be made on all shipments. • The goods are controlled until the importer commits to pay for the shipment. • The issuing bank will be responsible to ensure that the terms and conditions of the letter of credit are adhered to. • The exporter is guaranteed payments as long as the terms and conditions of the letter of credit are complied with. • Caters to diverse commercial and financial transactions. • Exporters may also avail of discounting facilities if required. • Importers may look at the possibility of refinancing the letter of credit. • Traders can use a transferable letter of credit to transfer all or a portion of it to their suppliers.

Product Rules	• Clients are required to provide all identification and proof of address documents, as required by FICA. • Authorised dealers may require a qualifying account, such as a cheque account. • Clients must be satisfied that the product meets their specific needs, and that fees and charges are affordable, particularly in instances where sales consultants are not authorised to provide advice. • The importer will need the data from the sales contract, as well as the documentation that is required to bring the goods into the importing country, in order to be able to complete the LC application form. • The exporter will need to present the documents called for by the LC in the condition and time period required by the LC.
Term	The service is available to clients on demand.
Fees/ Pricing	All exchange rates are updated regularly. These rates are indicative and exclude commissions and charges which differ from bank to bank. Rates may differ due to changing market conditions and the amount of the transaction.
Tax Implications	There might be tax implications, such as capital gains tax and value-added tax.
Risk	Low risk.
Suitability to investor	Suitable to clients who are involved in import and export activities.

4.3 Forex Alternatives

Investors and traders can get exposure to the forex market without directly trading in currencies. This is especially important for clients who may have specific forex investment objectives that may be better achieved with other forex alternatives.

The main forex alternatives discussed in this section are:

- Currency exchange-traded funds
- Currency futures
- Currency options
- Cryptocurrencies

4.3.1 Currency Exchange-Traded Funds

Exchange-traded funds (ETF) is an investment fund that is traded on an exchange, hence the name exchange-traded. ETFs are in many ways, similar to collective investment schemes (CIS), except that ETFs are bought and sold on stock exchanges whereas collective investment schemes are bought and sold from the issuer. An ETF usually holds assets such as shares, bonds, currencies, futures contracts, and/or commodities.

Currency ETFs, just like other types of ETFs, can provide investors with cheap and seamless exposure to a basket of currencies in the forex market. Currency ETFs may hold different types of assets such as cash/currency deposits, short-term debt denominated in a particular currency or currencies, and/or forex derivative contracts.

4.3.2 Currency Derivatives

Currency derivatives are financial contracts which derive their value from the value of their underlying asset i.e., the currency. Currency derivatives market for the trading of currency futures and options and also provides market participants with an avenue to hedge against currency risk and diversify internationally or take a position on the movement of underlying foreign exchange rates. Currency derivatives are margin-based so traders can establish positions with a small cash outlay as an initial margin. An example of a currency derivatives market is the JSE's currency derivatives market.

Currency Futures

A currency Futures contract gives the holder the right to buy or sell an underlying currency at a specified rate at a specified future date. The underlying instrument of a currency futures contract traded on the JSE's currency derivatives market is the exchange rate between a foreign currency and the rand. Contracts are settled in rands and so there is no physical delivery of foreign currency.

Currency futures may be used by exporters, importers, investors and travellers who may use such contracts to hedge against exchange rate movements. Speculators can also use currency futures to profit from short-term price movement in currencies.

Currency Options

Currency options are contracts that give the buyer the right, but not the obligation, to buy or sell a currency at a specified rate on or before a specified future date. The buyer of a currency option pays a premium for this right to the seller. Currency options are one of the most popular ways for individuals, corporations and financial institutions to hedge against exchange rate movements.

4.3.3 Cryptocurrencies

A cryptocurrency is a form of digital currency built on blockchain technology, enabling peer-to-peer transactions without relying on a central authority, such as a government or a reserve bank. Ownership records of cryptocurrencies are maintained on a decentralized digital ledger, ensuring transparency and security.

Despite their growing global adoption, cryptocurrencies are not recognized as legal tender in South Africa. Instead, the South African Revenue Service (SARS) classifies cryptocurrencies as assets or trading stock for tax purposes. Due to their broader application beyond simple exchange, cryptocurrencies are also referred to as crypto assets, or simply cryptos.

Regulatory Status Under the FAIS Act

The Financial Sector Conduct Authority (FSCA) declared in General Notice 1350 of 2022 that crypto assets are now considered financial products under the Financial Advisory and Intermediary Services (FAIS) Act. This means that:

- Any individual or entity providing financial advice or intermediary services related to crypto assets must be registered as a Financial Services Provider (FSP).
- Operating without the required FSP licence constitutes a contravention of Section 7(1) of the FAIS Act and is considered a criminal offence unless exempted.
- A person convicted of unlicensed crypto financial services under Section 36(a) of the FAIS Act may face a fine of up to R10 million, imprisonment of up to 10 years, or both.

Temporary Licensing Exemptions

Alongside its declaration, the FSCA issued FAIS Notice 90 of 2022, which introduced temporary exemptions for certain entities. The notice:

1. Exempts specific entities from licensing requirements under the FAIS Act.
2. Temporarily permits unlicensed entities to continue operating, provided they meet specific conditions.

A draft exemption document was also published to exclude licensed crypto asset FSPs, key individuals, and representatives from specific General Code of Conduct and Fit and Proper requirements.

The following entities are exempt from licensing under the FAIS Act:

- Crypto asset miners
- Node operators
- Individuals providing financial services related to non-fungible tokens (NFTs)

Licensing Application Deadline

Entities required to register as crypto asset FSPs must have applied for a licence under Section 8 of the FAIS Act between 1 June and 30 November 2023.

The temporary exemption remains valid until the FSCA approves or rejects the licence application. However, if a provider fails to submit an application within the stipulated period, the exemption automatically lapses.

Unit 4 Summary

Clients engage in foreign currency transactions for various reasons, and the choice of foreign exchange products depends on their individual preferences and financial circumstances. To ensure that clients receive suitable recommendations, financial representatives must conduct a financial needs analysis to assess the client's specific requirements before advising on an appropriate forex solution.

Some common client needs in relation to foreign currency transactions include:

- A safe and secure method of sending money abroad.
- An efficient and reliable way to receive funds from international sources.
- Access to foreign currency notes or travel facilities for international trips.
- Foreign exchange investments for wealth diversification.
- Forex solutions for import and export transactions.

Authorised dealers provide a variety of foreign exchange solutions to cater to these needs, whether for personal travel, cross-border payments, investment opportunities, or trade-related transactions. Forex services offer a simple, secure, and convenient way to facilitate global transactions.

Some of the key foreign exchange solutions available include:

- Global Payment Facility – Enables individuals and businesses to transfer funds internationally.
- Global Receipts Facility – Allows for the secure receipt of international payments.
- MoneyGram & PayPal – Online and physical money transfer services for sending and receiving funds globally.
- Foreign Notes & Travel Cards – Provide access to physical foreign currency or prepaid cards for travel purposes.
- Foreign Exchange Investments – Includes offshore investment products denominated in foreign currency.
- Letters of Credit – A financial instrument facilitating secure international trade transactions.

These foreign exchange solutions ensure that clients can manage their financial transactions globally with ease and efficiency while remaining compliant with South African exchange control regulations.