Foreign Exchange Markets Theory and Practice (Econ 383)
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Course Synopsis
This course is designed to give students an understanding of the structure of the foreign exchange market – the world’s largest market by turnover – the theoretical basis for currency movements and the interaction of foreign exchange and macro policy. At the end of the course, students will be familiar with the trading conventions and uses of the primary transaction vehicles – spot, forwards and options - a basic understanding of forecasting exchange rates, how currency can be used as an investment vehicle, pitfalls of currency exposure and the nature of currency crises. Course projects will be designed to give students some perception of the challenges faced by foreign exchange market professionals.

Class Meeting Times and Format
Classes will be lectures accompanied by power point slides; students are encouraged to actively participate by asking questions and challenging ideas and concepts introduced to the class. I intend to incorporate topical events into the classroom discussion and students are encouraged to alert the class to relevant articles and news events. I hold weekly office hours and am happy to arrange other times to meet.

While the lectures are based on a text (see below) lectures will have substantial additional content, especially, current journal articles with discussion of relevant current global events. Class attendance is highly encouraged and will be a component of your grade.


Lecture Notes: Lecture slides and will be posted to Course Works following each lecture with links to relevant supplemental readings

Projects and Grading: Your grade will be based on:

1) Term Paper on a selected currency (40%): Each student or team (you may be required to form teams depending on class size) will focus on a specific non-developed country currency and assess the following: Provide a one-year quarterly forecast of the currency against the US dollar and other major trading partners. Assess the potential for a currency crisis and what events would be most likely to trigger this and provide recommendations of the best means of hedging exposure to your currency.
2) Weekly assignments posing a variety of foreign exchange market challenges - e.g., determining attractive carry trades, building a currency portfolio, hedging exposure, pricing complex structures, etc. The weekly assignments will generally be relevant for the term paper (40%)

3) The class challenge: A list of exchange rates will be announced at the end of the first class and at the second class each student (and I) will be required to provide their forecast for where the exchange rate will close on the last day of class – we will see who is best! (5%)

4) Class Participation (15%)

Regrade Policy
My overall grading policy is that a weighted consistent numerical value will be attached to each assignment and the course grade will be based on the cumulative total for all assignments. So, a point ultimately is just a point regardless of what it might mean for your grade on a particular assignment. That said, for a grade reconsideration on any submitted work, it must be brought to my attention within one week of receipt. To avoid “grade grubbing”, you should only seek regrades if you think the difference is at least 2% of the total grade.

COURSE OUTLINE

Week One: Market Evolution, Structure and Instruments: An overview of the history of global monetary markets – especially the transition from the Gold Standard to Bretton Woods to where we are today – including the evolving role of international institutions and central banks and the regulatory environment. Following this will be a discussion on the structure of the market today including flow chains and the specific instruments that are traded – spot, forwards, futures, options and cross-currency swaps. Will also discuss quoting conventions in these markets and some examples of how rogue traders have been able to game the market – at least temporarily.

Week Two: Modeling and Forecasting Exchange Rates: An overview of the process and indicators that I utilized to achieve a twenty plus year career of success at advising clients on foreign exchange outlook. Start with an overview of the traditional drivers of exchange rates – especially real valuation and portfolio flows and, also provide some less traditional indicators I have found useful – relative yield curve flatness, risk sentiment, relative asset valuation. implied volatility skewing.

Week Three: Exchange Rate Regimes and Monetary Crises: An overview of the common forms of exchange rate regimes, including, pegged rates, exchange rate bands, currency boards, dual rates adopting another country’s currency and China’s unique currency arrangement. In each case we will look at what the regime implies for the central bank’s ability to pursue monetary policy and serve as lender of last resort and how regimes can either help or hinder control of inflation. We will also look what these factors portend for the long-term viability of the Euro and how exchange rate regimes can determine the nature of offshore markets – especially deliverable vs non-deliverable forwards – and why roughly 80% of the world’s currencies do not actively trade at all.
**Week Four: Exchange rates as an asset class:** Start with a general discussion of whether foreign exchange meets the definition of an asset class. We will then consider ways that currency exposure can be effectively brought into a broader portfolio. In this context, we will examine the fact that historically uncovered interest rate parity does not generally hold creating a risk-adjusted “excess” return. But this return has diminished substantially in recent years and we will investigate whether this is due to cyclical or secular factors – i.e., is the carry trade dead. We will also look at methods that compare outright carry vs the carry implied by the option skew.

**Week Five: Trends in exchange rate volatility and methods of trading volatility:** We will investigate why there has been a secular downtrend in volatility in foreign exchange markets for much of the past decade. In doing this we will determine the primary drivers of foreign exchange volatility and how they explain the volatility squeeze. We will also see that foreign exchange volatility is prone to spikes when currencies encounter crises. We will look at the general issue of currency crises and the inter-relationship with sovereign debt. Finally, a brief overview of how and why the volatility market in exchange rates is more sophisticated than any other markets with some examples of exotic option structures and the unique ability to trade correlation.

**Week Six: Accounting Conventions and the Implications for Hedging:** Start with a discussion of economic vs accounting exposure; why are they different and what this implies for hedging. Compare the benefits of hedging on a transactional basis vs a portfolio basis. Examining ways to hedge currencies that do not trade and more broadly looking at when proxy hedging makes sense and how to do it. Finally looking at ways to determine when it makes more sense to hedge via options rather than using forwards.