1) Common Questions About Currency Trading  
by Boris Schlossberg

Although forex is the largest financial market in the world, it is relatively unfamiliar terrain to retail traders. Until the popularization of internet trading a few years ago, FX was primarily the domain of large financial institutions, multinational corporations and secretive hedge funds. But times have changed, and individual investors are hungry for information on this fascinating market. Whether you are an FX novice or just need a refresher course on the basics of currency trading, read on to find the answers to the most frequently asked questions about the forex market.

How does this market differ from other markets?
Unlike the trading of stocks, futures or options, currency trading does not take place on a regulated exchange. It is not controlled by any central governing body, there are no clearing houses to guarantee the trades and there is no arbitration panel to adjudicate disputes. All members trade with each other based upon credit agreements. Essentially, business in the largest, most liquid market in the world depends on nothing more than a metaphorical handshake.

At first glance, this ad-hoc arrangement must seem bewildering to investors who are used to structured exchanges such as the NYSE or CME. (To learn more, see However, this arrangement works exceedingly well in practice: because participants in FX must both compete and cooperate with each other, self regulation provides very effective control over the market. Furthermore, reputable retail FX dealers in the United States become members of the National Futures Association (NFA), and by doing so they agree to binding arbitration in the event of any dispute. Therefore, it is critical that any retail customer who contemplates trading currencies do so only through an NFA member firm.

The FX market is different from other markets in some other key ways that are sure to raise eyebrows. Think that the EUR/USD is going to spiral downward? Feel free to short the pair at will. There is no uptick rule in FX as there is in stocks. There are also no limits on the size of your position (as there are in futures); so, in theory, you could sell $100 billion worth of currency if you had the capital to do it. If your biggest Japanese client, who also happens to golf with Toshihiko Fukui, the Governor of the Bank of Japan, told you on the golf course that BOJ is planning to raise rates at its next meeting, you could go right ahead and buy as much yen as you like. No one will ever prosecute you for insider trading should your bet pay off. There is no such thing as insider trading in FX; in fact, European economic data, such as German employment figures, are often leaked days before they are officially released.

Before we leave you with the impression that FX is the Wild West of finance, we should note that this is the most liquid and fluid market in the world. It trades 24 hours a day, from 5pm EST Sunday to 4pm EST Friday, and it rarely has any gaps in price. Its sheer size (it trades nearly US$2 trillion each day) and scope (from Asia to Europe to North America) makes the currency market the most accessible market in the world.

Where is the commission in FX?
Investors who trade stocks, futures or options typically use a broker, who acts as an
agent in the transaction. The broker takes the order to an exchange and attempts to execute it as per the customer's instructions. For providing this service, the broker is paid a commission when the customer buys and sells the tradable instrument.

The FX market does not have commissions. Unlike exchange-based markets, FX is a principals-only market. FX firms are dealers, not brokers. This is a critical distinction that all investors must understand. Unlike brokers, dealers assume market risk by serving as a counterparty to the investor's trade. They do not charge commission; instead, they make their money through the bid-ask spread.

In FX, the investor cannot attempt to buy on the bid or sell at the offer like in exchange-based markets. On the other hand, once the price clears the cost of the spread, there are no additional fees or commissions. Every single penny gain is pure profit to the investor. Nevertheless, the fact that traders must always overcome the bid/ask spread makes scalping much more difficult in FX.

What is a pip?

Pip stands for "percentage in point" and is the smallest increment of trade in FX. In the FX market, prices are quoted to the fourth decimal point. For example, if a bar of soap in the drugstore was priced at $1.20, in the FX market the same bar of soap would be quoted at 1.2000. The change in that fourth decimal point is called 1 pip and is typically equal to 1/100th of 1%. Among the major currencies, the only exception to that rule is the Japanese yen. Because the Japanese yen has never been revalued since the Second World War, 1 yen is now worth approximately US$0.08; so, in the USD/JPY pair, the quotation is only taken out to two decimal points (i.e. to 1/100th of yen, as opposed to 1/1000th with other major currencies).

What are you really selling or buying in the currency market?
The short answer is "nothing". The retail FX market is purely a speculative market. No physical exchange of currencies ever takes place. All trades exist simply as computer entries and are netted out depending on market price. For dollar-denominated accounts, all profits or losses are calculated in dollars and recorded as such on the trader's account.

The primary reason the FX market exists is to facilitate the exchange of one currency into another for multinational corporations who need to trade currencies continually (for example, for payroll, payment for costs of goods and services from foreign vendors, and merger and acquisition activity). However, these day-to-day corporate needs comprise only about 20% of the market volume. Fully 80% of trades in the currency market are speculative in nature, put on by large financial institutions, multi-billion dollar hedge funds and even individuals who want to express their opinions on the economic and geopolitical events of the day.

Because currencies always trade in pairs, when a trader makes a trade he or she is always long one currency and short the other. For example, if a trader sells one standard lot (equivalent to 100,000 units) of EUR/USD, she would, in essence, have exchanged euros for dollars and would now be "short" euro and "long" dollars. To better understand this dynamic, let's use a concrete example. If you went into an electronics store and purchased a computer for $1,000, what would you be doing? You would be exchanging your dollars for a computer. You would basically be "short" $1,000 and "long" 1 computer. The store would be "long" $1,000 but now "short" 1 computer in its inventory.
The exact same principle applies to the FX market, except that no physical exchange takes place. While all transactions are simply computer entries, the consequences are no less real.

**Which currencies are traded?**

Although some retail dealers trade exotic currencies such as the Thai baht or the Czech koruna, the majority trade the seven most liquid currency pairs in the world, which are the four majors:

- EUR/USD (euro/dollar)
- USD/JPY (dollar/Japanese yen)
- GBP/USD (British pound/dollar)
- USD/CHF (dollar/Swiss franc)

and the three commodity pairs:

- AUD/USD (Australian dollar/dollar)
- USD/CAD (dollar/Canadian dollar)
- NZD/USD (New Zealand dollar/dollar)

These currency pairs, along with their various combinations (such as EUR/JPY, GBP/JPY and EUR/GBP) account for more than 95% of all speculative trading in FX. Given the small number of trading instruments - only 18 pairs and crosses are actively traded - the FX market is far more concentrated than the stock market.

**What is carry?**

Carry is the most popular trade in the currency market, practiced by both the largest hedge funds and the smallest retail speculators. The carry trade rests on the fact that every currency in the world has an interest rate attached to it. These short-term interest rates are set by the central banks of these countries: the Federal Reserve in the U.S., the Bank of Japan in Japan and the Bank of England in the U.K.

The idea behind the carry is quite straightforward. The trader goes long the currency with a high interest rate and finances that purchase with a currency with a low interest rate. In 2005, one of the best pairings was the NZD/JPY cross. The New Zealand economy, spurred by huge commodity demand from China and a hot housing market, has seen its rates rise to 7.25% and stay there (at the time of writing), while Japanese rates have remained at 0%. A trader going long the NZD/JPY could have harvested 725 basis points in yield alone. On a 10:1 leverage basis, the carry trade in NZD/JPY could have produced a 72.5% annual return from interest rate differentials alone without any contribution from capital appreciation. Now you can understand why the carry trade is so popular! But before you rush out and buy the next high-yield pair, be aware that when the carry trade is unwound, the declines can be rapid and severe. This process is known as carry trade liquidation and occurs when the majority of speculators decide that the carry trade may not have future potential. With every trader seeking to exit his or her position at once, bids disappear and the profits from interest rate differentials are not nearly enough to offset the capital losses. Anticipation is the key to success: the best time to position in the carry is at the beginning of the rate-tightening cycle, allowing the trader to ride the move as interest rate differentials increase.
FX Jargon
Every discipline has its own jargon, and the currency market is no different. Here are some terms to know that will make you sound like a seasoned currency trader:

- **Cable, sterling, pound** - alternative names for the GBP
- **Greenback, buck** - nicknames for the U.S. dollar
- **Swissie** - nickname for the Swiss franc
- **Aussie** - nickname for the Australian dollar
- **Kiwi** - nickname for the New Zealand dollar
- **Loonie, the little dollar** - nicknames for the Canadian dollar
- **Figure** - FX term connoting a round number like 1.2000
- **Yard** - a billion units, as in "I sold a couple of yards of sterling."
2) The Foreign Exchange Interbank Market
by Kathy Lien

According to an April 2004 report by the Bank for International Settlements, the foreign exchange market has an average daily volume of close to $2,000 billion, making it the largest market in the world. Unlike most other exchanges such as the New York Stock Exchange or the Chicago Board of Trade, the FX market is not a centralized market. In a centralized market, each transaction is recorded by price dealt and volume traded. There is usually one central place back to which all trades can be traced and there is often one specialist or market maker. The currency market, however, is a decentralized market. There isn't one "exchange" where every trade is recorded. Instead, each market maker records his or her own transactions and keeps it as proprietary information. The primary market makers who make bid and ask spreads in the currency market are the largest banks in the world. They deal with each other constantly either on behalf of themselves or their customers. This is why the market on which banks conduct transactions is called the interbank market.

The competition between banks ensures tight spreads and fair pricing. For individual investors, this is the source of price quotes and is where forex brokers offset their positions. Most individuals are unable to access the pricing available on the interbank market because the customers at the interbank desks tend to include the largest mutual and hedge funds in the world as well as large multinational corporations who have millions (if not billions) of dollars. Despite this, it is important for individual investors to understand how the interbank market works because it is one the best ways to understand how retail spreads are priced, and to decide whether you are getting fair pricing from your broker. Read on to find out how this market works and how its inner workings can affect your investments.

Who makes the prices?
Trading in a decentralized market has its advantages and disadvantages. In a centralized market, you have the benefit of seeing volume in the market as a whole but at the same time, prices can easily be skewed to accommodate the interests of the specialist and not the trader. The international nature of the interbank market can make it difficult to regulate, however, with such important players in the market, self-regulation is sometimes even more effective than government regulations. For the individual investor, a forex broker must be registered with the Commodity Futures Trading Commission as a futures commission merchant and be a member of the National Futures Association (NFA). The CFTC regulates the broker and ensures that he or she meets strict financial standards.

According to the "Wall Street Journal Europe" (February 2006), 73% of total forex volume is done through 10 banks. These banks are the brand names that we all know well, including Deutsche Bank, UBS, Citigroup and HSBC. Each bank is structured differently but most banks will have a separate group known as the Foreign Exchange Sales and Trading Department. This group is responsible for making prices for the bank's clients and for offsetting that risk with other banks. Within the Foreign Exchange group, there is a sales and a trading desk. The sales desk is generally responsible for taking the orders from the client, getting a quote from the spot trader and relaying the quote to the client to see if they want to deal on it. This three-step process is quite common because even though online foreign exchange trading is available, many of the large clients who deal anywhere from $10 million to $100 million at a time (cash on cash),
believe that they can get better pricing dealing over the phone than over the trading platform. This is because most platforms offered by banks will have a trading size limit because the dealer wants to make sure that it is able to offset the risk.

On a foreign exchange spot trading desk, there are generally one or two market makers responsible for each currency pair. That is, for the EUR/USD, there is only one primary dealer that will give quotes on the currency. He or she may have a secondary dealer that gives quotes on a smaller transaction size. This setup is mostly true for the four majors where the dealers see a lot of activity. For the commodity currencies, there may be one dealer responsible for all three commodity currencies or, depending upon how much volume the bank sees, there may be two dealers.

This is important because the bank wants to make sure that each dealer knows its currency well and understands the behavior of the other players in the market. Usually, the Australian dollar dealer is also responsible for the New Zealand dollar and there is often a separate dealer making quotes for the Canadian dollar. There usually isn't a "crosses" dealer - the primary dealer responsible for the more liquid currency will make the quote. For example, the Japanese yen trader will make quotes on all yen crosses. Finally, there is one additional dealer that is responsible for the exotic currencies such as the Mexican peso and the South African rand. This setup is mimicked usually across three trading centers - London, New York and Tokyo. Each center passes the client orders and positions to another trading center at the end of the day to ensure that client orders are watched 24 hours a day.

How do banks determine the price?
Bank dealers will determine their prices based upon a variety of factors including, the current market rate, how much volume is available at the current price level, their views on where the currency pair is headed and their inventory positions. If they think that the euro is headed higher, they may be willing to offer a more competitive rate for clients that want to sell euros because they believe that once they are given the euros, they can hold onto them for a few pips and offset at a better price. On the flip side, if they think that the euro is headed lower and the client is giving them euros, they may offer a lower price because they are not sure if they can sell the euro back to the market at the same level at which it was given to them. This is something that is unique to market makers that do not offer a fixed spread.

How does a bank offset risk?
Similar to the way we see prices on an electronic forex broker's platform, there are two primary platforms that interbank traders use: one is offered by Reuters Dealing and the other is offered by the Electronic Brokerage Service (EBS). The interbank market is a credit-approved system in which banks trade based solely on the credit relationships they have established with one another. All of the banks can see the best market rates currently available; however, each bank must have a specific credit relationship with another bank in order to trade at the rates being offered. The bigger the banks, the more credit relationships they can have and the better pricing they will be able access. The same is true for clients such as retail forex brokers. The larger the retail forex broker in terms of capital available, the more favorable pricing it can get from the interbank market. If a client or even a bank is small, it is restricted to dealing with only a select number of larger banks and tends to get less favorable pricing.
Both the EBS and Reuters Dealing systems offer trading in the major currency pairs, but certain currency pairs are more liquid and are traded more frequently over either EBS or Reuters Dealing. These two companies are continually trying to capture each other's market shares, but as a guide, the following is the breakdown where each currency pair is primarily traded:

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Cross currency pairs are generally not quoted on either platform, but are calculated based on the rates of the major currency pairs and then offset through the legs. For example, if an interbank trader had a client who wanted to go long EUR/CAD, the trader would most likely buy EUR/USD over the EBS system and buy USD/CAD over the Reuters platform. The trader then would multiply these rates and provide the client with the respective EUR/CAD rate. The two-currency-pair transaction is the reason why the spread for currency crosses, such as the EUR/CAD, tends to be wider than the spread for the EUR/USD.

The minimum transaction size of each unit that can be dealt on either platforms tends to one million of the base currency. The average one-ticket transaction size tends to five million of the base currency. This is why individual investors can't access the interbank market - what would be an extremely large trading amount (remember this is unleveraged) is the bare minimum quote that banks are willing to give - and this is only
for clients that trade usually between $10 million and $100 million and just need to clear up some loose change on their books.

**Conclusion**

Individual clients then rely on online market makers for pricing. The forex brokers use their own capital to gain credit with the banks that trade on the interbank market. The more well capitalized the market makers, the more credit relationships they can establish and the more competitive pricing they can access for themselves as well as their clients. This also means that when markets are volatile, the banks are more obligated to give their good clients continuously competitive pricing. Therefore, if a forex retail broker is not well capitalized, how they can access more competitive pricing than a well capitalized market maker remains questionable. The structure of the market makes it extremely difficult for this to be the case. As a result, it is extremely important for individual investors to do extensive due diligence on the forex broker with which they choose to trade.
3) A Primer On The Forex Market
by Jason Van Bergen

With the increasingly widespread availability of electronic trading networks, trading on the currency exchanges is now more accessible than ever. The foreign exchange market, or forex, is notoriously the domain of government central banks and commercial and investment banks, not to mention hedge funds and massive international corporations. At first glance, the presence of such heavyweight entities may appear rather daunting to the individual investor. But the presence of such powerful groups and such a massive international market can also work to the benefit of the individual trader. The forex offers trading 24-hours a day, five days a week, and the daily dollar volume of currencies traded in the currency market exceeded $3 trillion in 2007 (according to the 2007 Triennial Central Bank Survey of Foreign Exchange and Derivative Market Activity), making it the largest and most liquid market in the world.

Trading Opportunities
The sheer number of currencies traded serves to ensure a rather extreme level of volatility on a day-to-day basis. There will always be currencies that are moving rapidly up or down, offering opportunities for profit (and commensurate risk) to astute traders. Yet, like the equity markets, forex offers plenty of instruments to mitigate risk and allows the individual to profit in both rising and falling markets. Forex also allows highly leveraged trading with low margin requirements relative to its equity counterparts. Perhaps best of all, forex charges zero dealing commissions!

Many of the instruments utilized in forex - such as forwards and futures, options, spread betting, contracts for difference and the spot market - will appear similar to those used in the equity markets. Since the instruments on the forex often maintain minimum trade sizes in terms of the base currencies (the spot market, for example, requires a minimum trade size of 100,000 units of the base currency), the use of margin is absolutely essential for the person trading these instruments.

Buying and Selling Currencies
Regarding the specifics of buying and selling on forex, it is important to note that currencies are always priced in pairs. All trades result in the simultaneous purchase of one currency and the sale of another. This necessitates a slightly different mode of thinking than what you might be used to. While trading on the forex, you would execute a trade only at a time when you expect the currency you are buying to increase in value relative to the one you are selling. If the currency you are buying does increase in value, you must sell the other currency back in order to lock in a profit. An open trade (or open position), therefore, is a trade in which a trader has bought or sold a particular currency pair and has not yet sold or bought back the equivalent amount to close the position.

Base and Counter Currencies and Quotes
Currency traders must become familiar also with the way currencies are quoted. The first currency in the pair is considered the base currency; and the second is the counter or quote currency. Most of the time, U.S. dollar is considered the base currency, and quotes are expressed in units of US$1 per counter currency (for example, USD/JPY or USD/CAD). The only exceptions to this convention are quotes in relation to the euro, the pound sterling and the Australian dollar - these three are quoted as dollars per foreign currency.
Forex quotes always include a bid and an ask price. The bid is the price at which the market maker is willing to buy the base currency in exchange for the counter currency. The ask price is the price at which the market maker is willing to sell the base currency in exchange for the counter currency. The difference between the bid and the ask prices is referred to as the spread.

The cost of establishing a position is determined by the spread, and prices are always quoted using five numbers (for example, 134.85), the final digit of which is referred to as a point or a pip. For example, if USD/JPY was quoted with a bid of 134.85 and an ask of 134.90, the five-pip spread is the cost of trading this position. From the very start, therefore, the trader must recover the five-pip cost from his or her profits, necessitating a favorable move in the position in order simply to break even.

More about Margin
Trading in the currency markets requires a trader to think in a slightly different way also about margin. Margin on the forex is not a down payment on a future purchase of equity but a deposit to the trader's account that will cover against any currency-trading losses in the future. A typical currency trading system will allow for a very high degree of leverage in its margin requirements, up to 100:1. The system will automatically calculate the funds necessary for current positions and will check for margin availability before executing any trade.

Rollover
In the spot forex market, trades must be settled within two business days. For example, if a trader sells a certain number of currency units on Wednesday, he or she must deliver an equivalent number of units on Friday. But currency trading systems may allow for a "rollover", with which open positions can be swapped forward to the next settlement date (giving an extension of two additional business days). The interest rate for such a swap is predetermined, and, in fact, these swaps are actually financial instruments that can also be traded on the currency market.

In any spot rollover transaction the difference between the interest rates of the base and counter currencies is reflected as an overnight loan. If the trader holds a long position in the currency with the higher interest rate, he or she would gain on the spot rollover. The amount of such a gain would fluctuate day-to-day according to the precise interest-rate differential between the base and the counter currency. Such rollover rates are quoted in dollars and are shown in the interest column of the forex trading system. Rollovers, however, will not affect traders who never hold a position overnight since the rollover is exclusively a day-to-day phenomenon.

Conclusion
As one can immediately see, trading in forex requires a slightly different way of thinking than the way required by equity markets. Yet, for its extreme liquidity, multitude of opportunities for large profits due to strong trends and high levels of available leverage, the currency market are hard to resist for the advanced trader. With such potential, however, comes significant risk, and traders should quickly establish an intimate familiarity with methods of risk management.