Forex

What is forex trading?

Forex (foreign exchange) is a network on which buyers and sellers exchange a currency at a predetermined price and the means by which individual traders, companies and central banks convert one currency into another. If you have travelled abroad, you have probably already performed a forex transaction.

Such operations are often carried out for practical reasons, but most foreign exchange conversions have the objective of making a profit. The volume of currencies converted each day is capable of making the price movements of certain currencies extremely volatile. Such volatility is one of the reasons why forex is so fascinating to investors. Yet the higher potential profit also implies higher exposure to risk.

How do foreign exchange markets work?

Unlike equities or commodities, forex trades do not occur on stock exchanges. In fact, the currencies are exchanged directly between two parties on the OTC (Over-The-Counter) market That means that the forex market operates over a global network of banks spread over four main trading centers in different time zones: London, New York, Sydney and Tokyo. Moreover, since there is no single hub through which all the transactions have to pass, all the transactions can be kept running 24 hours a day.

There are three different types of forex markets:

- **Spot**: the physical exchange of a currency pair that occurs simultaneously with the agreed purchase and sale ("on the spot", in the sense of "immediately") or after a short maturity
- **Forward**: an agreement between two parties to buy and sell a given sum of money in a certain currency at a specified price by a certain future date
- **Future**: an agreement under which two parties agree to buy and sell a given sum of money in one currency at a specified on a specific future date. Forwards are over-the-counter and customized agreements between two counterparties, while Futures are standardized contracts traded on exchanges.

Most traders exploit forex price movements without actually taking delivery of the currency itself. They speculate on prices and forecast the exchange rates in order to profit from market movements.

What is a base currency?

A base currency is the first currency shown in a currency pair, whereas the second currency is known as the quote currency or counter currency. In forex trading, selling one currency always involves buying the other currency quoted in the pair. The price of a currency pair equals the amount of the counter currency needed to buy one unit of the base currency.

Each currency in every pair is designated by a three-letter code (forex symbol), of which two letters indicate the region and one letter the name of the currency. For example, GBP/USD represents a currency pair that involves the purchase of Great Britain Pounds and the sale of United States Dollars.

Most brokers classify the currency pairs as follows:

- **major currency pairs:** these are the seven currency pairs that account for 80% of global trades: EUR/USD, USD/JPY, GBP/USD and USD/CHF are a few of the most important currency pairs
- **minor currency pairs:** these pairs are exchanged less often and usually contain the main currencies that are quoted against each other rather than on the basis of the US Dollar, such as the pairs EUR/GBP, EUR/CHF and GBP/JPY
- **exotic currency pairs:** a major currency against the currency of a minor or emerging economy; for example, USD/PLN, GBP/ MXN and EUR/CZK
- **regional currency pairs:** these are forex pairs classified on the regional scale, such as the Scandinavian or Asia-Pacific pairs: EUR/NOK, AUD/NZD and AUD/SGD

What factors influence the forex market?

The forex market includes all global currencies so it is very difficult to accurately predict the exchange rate because of the multiple factors that influence price movements. Yet, like most financial markets, the forex market depends on trends in supply and demand. It is therefore crucial to understand all the factors that influence market fluctuations.

Central Banks: Supply is controlled by the central banks, which can take measures having a significant impact on currency prices.

News and financial events: Banks and investors tend to invest their own money in sound economies. This means that if good news concerns a certain area, investing in that area will be encouraged, which will increase demand for the currency of that region. Unless an equivalent increase occurs in the supply of the relevant currency, the imbalance between demand and supply will lead to a price increase. In the same way, bad news may inhibit investments, resulting in a fall of the currency price. For that reason, currencies tend to reflect an economy's state of health.

How does forex trading work?

There are different ways of trading on the forex market and they all work the same way: the purchase of one currency simultaneously involves the sale of another currency. In fact, forex trading is traditionally carried out through a broker but with the increasing popularity of online trading, you can take advantage of price movements thanks to derivative instruments like CFDs. CFDs and options are leveraged products that let you open a position by investing only part of the total value of the transaction. Unlike unleveraged products, you do not have to actually possess the asset, so you can trade on both bull and bear markets. Financial leverage makes it possible to increase profits but it also involves a risk of incurring high losses in the event of unfavourable market movements.

What is the "spread" in forex trading?

The spread is the difference between the purchase price and the selling price quoted for a forex pair. As in many financial markets, two prices are displayed when you open a forex position. If you want to open a long position, you will have to trade at the ask price, which is slightly higher than the market price. If you want to open short position, in contrast, you will have to trade at the bid price, which is slightly lower than the market price.

What is a "lot"?

Currencies are traded in lots, i.e. units of currencies used for the purpose of standardizing forex trading. Since forex movements are small, lots are generally quite big: one standard lot equals 100,000 units of the relevant currency. Individual traders may not have ready access to GBP/USD/EUR or CHF 100,000 of capital to invest in every single order.

What is "leverage" in forex trading?

Leverage makes it possible to obtain exposure on a considerable amount of money in a certain currency without having to pay the full amount but only a lesser amount known as the "margin" . When you close out a leveraged position, the profit and loss are based on the total value of the transaction. Leverage can amplify potential profits but it may also increase the risk of losses exceeding your own deposits. It is therefore extremely important to learn how to manage risk and protect your investments against possible consequences of the leverage effect.

What is the margin?

The margin is a key factor in leveraged trading. The margin is the part of the funds required to open a leveraged position. If you trade on the forex market and use financial leverage, the margin requirement may change based on the broker and the size of your position. The margin is generally expressed as a percentage of your total position. This means that a EUR/CHF trade, for example, may only require a margin equal to 1.5% of the total value in order to open the position. Instead of CHF 100,000, you will only have to deposit CHF 1,500.

What is a pip?

Pips are units that measures the movements of a forex pair. A pip equals a movement by one unit of the fourth decimal place of a forex pair. This means that if the EUR/ CHF pair changes from CHF 1.13**80**9 to CHF 1.13**81**9, it has changed by one pip. The decimal places following the pip are called fractional pips.

In exceptional cases, such as the Japanese Yen, the secondary currency may be expressed in much smaller denominations. In fact, in the case of yen, a change in the second decimal place represents a single pip. This means that if the EUR/JPY pair moves from ¥106.**45**2 to ¥106.**46**2, a movement by a single pip is recorded.

DISCLAIMER

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