Top 6 questions about currency trading

By Boris Schlossberg | Updated March 1, 2018 — 5:02 PM EST

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Although forex is the largest financial market in the world, it is relatively unfamiliar terrain for retail traders. Until the popularization of internet trading a few years ago, forex (FX) was primarily the domain of large financial institutions, multinational corporations and 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, we'll address some of the most frequently asked questions about the FX market. (See also our **Foreign Exchange** tutorial.)

1. How Does the Forex Market Differ from other Markets?

Unlike 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 on credit agreements. Essentially, business in the largest, most liquid marketin 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 "Getting to Know Stock Exchanges.") However, this arrangement works exceedingly well in practice. Self regulation provides very effective control over the market because participants in FX must both compete and cooperate with each other. Furthermore, reputable retail FX dealers in the U.S. become members of the National Futures Association (NFA), and by doing so 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. Interestingly enough, if your biggest Japanese client, who also happens to golf with the governor of the Bank of Japan, tells 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 5 p.m. EST Sunday to 4 p.m. EST Friday, and it rarely has any gaps in price. Its sheer size and scope (from Asia to Europe to North America) makes the currency market the most accessible in the world. (See also reviews of forex brokers.)

[Note: Since the forex market is a 24-hour market, there tends to be a large amount of data that can be used to gauge future price movements. This makes it the perfect market for traders that use technical tools. If you want to learn more about technical analysis from one of the world's most widely followed technical analysts, check out Investopedia Academy's Technical Analysis course.]

2. Where Is the Commission in Forex Trading?

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 per the customer's instructions. The broker is paid a commission when the customer buys and sells the tradable instrument for providing this service.

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 gained 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. (To learn more, see "Scalping: Small Quick Profits Can Add Up.")

3. What Is a Pip in Forex Trading?

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. One Japanese yen is now worth approximately US$0.01; 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).

4. 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 that need to continually trade currencies (i.e., for payroll, payment for costs of goods and services from foreign vendors, and mergers and acquisitions). However, these day-to-day corporate needs comprise only about 20% of the market volume. There are 80% of trades in the currency market that are speculative in nature, put on by large financial institutions, multibillion-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 they are 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, they would have exchanged euros for dollars and would now be "short" euros and "long" dollars. To better understand this dynamic, 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" one computer. The store would be "long" $1,000, but now "short" one computer in its inventory. The 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.

5. Which Currencies Are Traded in the Forex Market?

Although some retail dealers trade exotic currenciessuch 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. (To read more, check out "Popular Forex Currencies.")

6. What Is a Currency Carry Trade?

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 carry is quite straightforward. The trader goes long the currency with a high interest rate and finances that purchase with a currency that has a low interest rate. For example, 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, saw its rates rise to 7.25% and stay there, while Japanese rates 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, 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 advised 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. (To learn more about this type of trade, see "Currency Carry Trades 101.")

Knowing Your Forex 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."