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## Introduction

[Foreign exchange](#) (forex or FX for short) is one of the most exciting, fast-paced markets around. Until recently, trading in the forex market had been the domain of large financial institutions, corporations, [central banks](#), hedge funds and extremely wealthy individuals. The emergence of the internet has changed all of this, and now it is possible for average investors to buy and sell [currencies](#) easily with the click of a mouse.

Daily currency fluctuations are usually very small. Most [currency pairs](#) move less than one cent per day, representing a less than 1% change in the value of the currency. This makes foreign exchange one of the least volatile financial markets around. Therefore, many speculators rely on the availability of enormous leverage to increase the value of potential movements. In the forex market, [leverage](#) can be as much as 250:1. Higher leverage can be extremely risky, but because of round-the-clock trading and deep [liquidity](#), foreign exchange brokers have been able to make high leverage an industry standard in order to make the movements meaningful for FX traders.

Extreme liquidity and the availability of high leverage have helped to spur the market's rapid growth and made it the ideal place for many traders. Positions can be opened and closed within minutes or can be held for months. Currency prices are based on objective considerations of [supply](#) and [demand](#) and cannot be manipulated easily because the size of the market does not allow even the largest players, such as central banks, to move prices at will.

The forex market provides plenty of opportunity for investors. However, in order to be successful, a currency trader has to understand the basics behind currency movements.

The goal of this tutorial is to provide a foundation for investors or traders who are new to the currency markets. We'll cover the basics of foreign exchange, its history and the key concepts you need to understand in order to be able to participate in this market. We'll also venture into how to start trading currencies and the different types of strategies that can be employed.

## What Is It?

The foreign exchange market is the "place" where currencies are traded. Currencies are important to most people around the world, whether they realize it or not, because currencies need to be exchanged in order to conduct foreign trade and business. If you are living in the U.S. and want to buy cheese from France, either you or the company that you buy the cheese from has to pay the French for the cheese in [euros](#) (EUR). This means that the U.S. importer would have to exchange the equivalent value of U.S. dollars (USD) into euros. The same goes for traveling. A French tourist in Egypt can't pay in euros to see the pyramids because it's not the locally accepted currency. As such, the tourist has to exchange the euros for the local currency, in this case the Egyptian pound, at the current exchange rate.

The need to exchange currencies is the primary reason why the forex market is the largest, most liquid financial market in the world. It dwarfs other markets in size, even the stock market, with an average traded value of around U.S. \$2,000 billion per day. (The total volume changes all the time, but as of April 2004, the [Bank for International Settlements](#) (BIS) reported that the forex market traded U.S. \$1,900 billion per day.)

One unique aspect of this international market is that there is no central marketplace for currency exchange. Rather, trade is conducted electronically [over-the-counter](#) (OTC), which means that all transactions occur via computer networks between traders around the world, rather than on one centralized

exchange. The market is open 24 hours a day, five and a half days a week, and currencies are traded worldwide in the major financial centers of London, New York, Tokyo, Zurich, Frankfurt, Hong Kong, Singapore, Paris and Sydney - across almost every time zone. This means that when the trading day in the U.S. ends, the forex market begins anew in Tokyo and Hong Kong. As such, the forex market can be extremely active any time of the day, with price quotes changing constantly.

### **Spot Market and the Forwards and Futures Markets**

There are actually three ways that institutions, corporations and individuals trade forex: the [spot market](#), the [forwards market](#) and the [futures market](#). The spot market always has been the largest market because it is the "underlying" real asset that the forwards and futures markets are based on. In the past, the futures market was the most popular venue for traders because it was available to individual investors for a longer period of time. However, with the advent of electronic trading, the spot market has witnessed a huge surge in activity and now surpasses the futures market as the preferred trading market for individual investors and speculators. When people refer to the forex market, they usually are referring to the spot market. The forwards and futures markets tend to be more popular with companies that need to hedge their foreign exchange risks out to a specific date in the future.

#### *Spot Market*

More specifically, the spot market is where currencies are bought and sold according to the current price. That price, determined by supply and demand, is a reflection of many things, including current [interest rates](#), economic performance, sentiment towards ongoing political situations (both locally and internationally), as well as the perception of the future performance of one currency against another. When a deal is finalized, this is known as a "spot deal". It is a bilateral transaction by which one party delivers an agreed-upon currency amount to the counter party and receives a specified amount of another currency at the agreed-upon exchange rate value. After a [position](#) is closed, the settlement is in cash. Although the spot market is commonly known as one that deals with transactions in the present (rather than the future), these trades actually take two days for settlement.

#### *Forwards and Futures Markets*

Unlike the spot market, the forwards and futures markets do not trade actual currencies. Instead they deal in contracts that represent claims to a certain currency type, a specific price per unit and a future date for settlement.

In the forwards market, [contracts](#) are bought and sold OTC between two parties, who determine the terms of the agreement between themselves.

In the futures market, [futures contracts](#) are bought and sold based upon a standard size and settlement date on public commodities markets, such as the [Chicago Mercantile Exchange](#). In the U.S., the [National Futures Association](#) regulates the futures market. Futures contracts have specific details, including the number of units being traded, delivery and settlement dates, and minimum price increments that cannot be customized. The exchange acts as a counterpart to the trader, providing clearance and settlement.

Both types of contracts are binding and are typically settled for cash for the exchange in question upon expiry, although contracts can also be bought and sold before they expire. The forwards and futures markets can offer protection against risk when trading currencies. Usually, big international corporations use these markets in order to hedge against future exchange rate fluctuations, but [speculators](#) take part in these markets as well. (For a more in-depth introduction to futures, see [Futures Fundamentals](#).)

Note that you'll see the terms: FX, forex, foreign-exchange market and currency market. These terms are synonymous and all refer to the forex market.

## Reading a Quote and Understanding the Jargon

One of the biggest sources of confusion for those new to the currency market is the standard for quoting currencies. In this section, we'll go over currency quotations and how they work in currency pair trades.

### Reading a Quote

When a currency is quoted, it is done in relation to another currency, so that the value of one is reflected through the value of another. Therefore, if you are trying to determine the exchange rate between the U.S. dollar (USD) and the Japanese yen (JPY), the quote would look like this:

**USD/JPY = 119.50**

This is referred to as a currency pair. The currency to the left of the slash is the [base](#) currency, while the currency on the right is called the [quote](#) or counter currency. The base currency (in this case, the U.S. dollar) is always equal to one unit (in this case, US\$1), and the quoted currency (in this case, the Japanese yen) is what that one base unit is equivalent to in the other currency. The quote means that US\$1 = 119.50 Japanese yen. In other words, US\$1 can buy 119.50 Japanese yen.

### **Direct Quote vs. Indirect Quote**

There are two ways to quote a currency pair, either [directly](#) or [indirectly](#). A direct quote is simply a currency pair in which the domestic currency is the base currency; while an indirect quote, is a currency pair where the domestic currency is the quoted currency. So if you were looking at the Canadian dollar as the domestic currency and U.S. dollar as the foreign currency, a direct quote would be CAD/USD, while an indirect quote would be USD/CAD. The direct quote varies the foreign currency, and the quoted, or domestic currency, remains fixed at one unit. In the indirect quote, on the other hand, the domestic currency is variable and the foreign currency is fixed at one unit.

For example, if Canada is the domestic currency, a direct quote would be 0.85 CAD/USD, which means with C\$1, you can purchase US\$0.85. The indirect quote for this would be the inverse (1/0.85), which is 1.18 USD/CAD and means that USD\$1 will purchase C\$1.18.

In the forex spot market, most currencies are traded against the U.S. dollar, and the U.S. dollar is frequently the base currency in the currency pair. In these cases, it is called a direct quote. This would apply to the above USD/JPY currency pair, which indicates that US\$1 is equal to 119.50 Japanese yen.

However, not all currencies have the U.S. dollar as the base. The Queen's currencies - those currencies that historically have had a tie with Britain, such as the British pound, Australian Dollar and New Zealand dollar - are all quoted as the base currency against the U.S. dollar. The euro, which is relatively new, is quoted the same way as well. In these cases, the U.S. dollar is the counter currency, and the exchange rate is referred to as an indirect quote. This is why the EUR/USD quote is given as 1.25, for example, because it means that one euro is the equivalent of 1.25 U.S. dollars.

Most currency exchange rates are quoted out to four digits after the decimal place, with the exception of the Japanese yen (JPY), which is quoted out to two decimal places.

### **Cross Currency**

When a currency quote is given without the U.S. dollar as one of its components, this is called a [cross currency](#). The most common cross currency pairs are the EUR/GBP, EUR/CHF and EUR/JPY. These currency pairs expand the trading possibilities in the forex market, but it is important to note that they do not have as much of a following (for example, not as actively traded) as pairs that include the U.S. dollar, which also are called the majors. (For more on cross currency, see [Make The Currency Cross Your Boss.](#))

## Bid and Ask

As with most trading in the financial markets, when you are trading a currency pair there is a [bid price](#) (buy) and an [ask price](#) (sell). Again, these are in relation to the base currency. When buying a currency pair (going [long](#)), the ask price refers to the amount of quoted currency that has to be paid in order to buy one unit of the base currency, or how much the market will sell one unit of the base currency for in relation to the quoted currency.

The bid price is used when selling a currency pair (going [short](#)) and reflects how much of the quoted currency will be obtained when selling one unit of the base currency, or how much the market will pay for the quoted currency in relation to the base currency.

The quote before the slash is the bid price, and the two digits after the slash represent the ask price (only the last two digits of the full price are typically quoted). Note that the bid price is always smaller than the ask price. Let's look at an example:

**USD/CAD = 1.2000/05**  
**Bid = 1.2000**  
**Ask = 1.2005**

If you want to buy this currency pair, this means that you intend to buy the base currency and are therefore looking at the ask price to see how much (in Canadian dollars) the market will charge for U.S. dollars. According to the ask price, you can buy one U.S. dollar with 1.2005 Canadian dollars.

However, in order to sell this currency pair, or sell the base currency in exchange for the quoted currency, you would look at the bid price. It tells you that the market will buy US\$1 base currency (you will be selling the market the base currency) for a price equivalent to 1.2000 Canadian dollars, which is the quoted currency.

Whichever currency is quoted first (the base currency) is always the one in which the transaction is being conducted. You either buy or sell the base currency. Depending on what currency you want to use to buy or sell the base with, you refer to the corresponding currency pair [spot exchange rate](#) to determine the price.

## Spreads and Pips

The difference between the bid price and the ask price is called a spread. If we were to look at the following quote: EUR/USD = 1.2500/03, the spread would be

0.0003 or 3 [pips](#), also known as points. Although these movements may seem insignificant, even the smallest point change can result in thousands of dollars being made or lost due to [leverage](#). Again, this is one of the reasons that [speculators](#) are so attracted to the forex market; even the tiniest price movement can result in huge profit.

The pip is the smallest amount a price can move in any currency quote. In the case of the U.S. dollar, euro, British pound or Swiss franc, one pip would be 0.0001. With the Japanese yen, one pip would be 0.01, because this currency is quoted to two decimal places. So, in a forex quote of USD/CHF, the pip would be 0.0001 Swiss francs. Most currencies trade within a range of 100 to 150 pips a day.

Currency Quote Overview		
USD/CAD = 1.2232/37		
<b>Base Currency</b>	Currency to the left (USD)	
<b>Quote/Counter Currency</b>	Currency to the right (CAD)	
<b>Bid Price</b>	1.2232	Price for which the market maker will buy the base currency. Bid is always smaller than ask.
<b>Ask Price</b>	1.2237	Price for which the market maker will sell the base currency.
<b>Pip</b>	One point move, in USD/CAD it is .0001 and 1 point change would be from 1.2231 to 1.2232	The pip/point is the smallest movement a price can make.
<b>Spread</b>	Spread in this case is 5 pips/points; difference between bid and ask price (1.2237-1.2232).	

### Currency Pairs in the Forwards and Futures Markets

One of the key technical differences between the forex markets is the way currencies are quoted. In the forwards or futures markets, foreign exchange always is quoted against the U.S. dollar. This means that pricing is done in terms of how many U.S. dollars are needed to buy one unit of the other currency. Remember that in the spot market some currencies are quoted against the U.S. dollar, while for others, the U.S. dollar is being quoted against them. As such, the forwards/futures market and the spot market quotes will not always be parallel one another.

For example, in the spot market, the British pound is quoted against the U.S. dollar as GBP/USD. This is the same way it would be quoted in the forwards and futures markets. Thus, when the British pound strengthens against the U.S.

dollar in the spot market, it will also rise in the forwards and futures markets.

On the other hand, when looking at the exchange rate for the U.S. dollar and the Japanese yen, the former is quoted against the latter. In the spot market, the quote would be 115 for example, which means that one U.S. dollar would buy 115 Japanese yen. In the futures market, it would be quoted as (1/115) or .0087, which means that 1 Japanese yen would buy .0087 U.S. dollars. As such, a rise in the USD/JPY spot rate would equate to a decline in the JPY futures rate because the U.S. dollar would have strengthened against the Japanese yen and therefore one Japanese yen would buy less U.S. dollars.

Now that you know a little bit about how currencies are quoted, let's move on to the benefits and risks involved with trading forex.

## Benefits and Risks

In this section, we'll take a look at some of the benefits and risks associated with the forex market. We'll also discuss how it differs from the equity market in order to get a greater understanding of how the forex market works.

### The Good and the Bad

We already have mentioned that factors such as the size, volatility and global structure of the forex market have all contributed to its rapid success. Given the highly liquid nature of this market, investors are able to place extremely large trades without affecting any given exchange rate. These large positions are made available to traders because of the low margin requirements used by the majority of the industry's brokers. For example, it is possible for an investor to control a position of US\$100,000 by putting down as little as US\$1,000 up front and borrowing the remainder from his or her broker. This amount of leverage acts as a double-edged sword because investors can realize large gains when rates make a small favorable change, but they also run the risk of a massive loss when the rates move against them. Despite the risks, the amount of leverage available in the forex market is what makes it attractive for many speculators.

The currency market is also the only market that is truly open 24 hours a day with decent liquidity throughout the day. For traders who may have a day job or just a busy schedule, it is an optimal market to trade in. As you can see from the chart below, the major trading hubs are spread throughout many different time zones, eliminating the need to wait for an opening or closing bell. As the U.S. trading closes, other markets in the East are opening, making it possible to trade at any time during the day.

Time Zone	Time (ET)
Tokyo Open	7:00 pm

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Tokyo Close	4:00 am
London Open	3:00 am
London Close	12:00 pm
New York Open	8:00 am
New York Close	5:00 pm

While the forex market may offer more excitement to the investor, the risks are also higher in comparison to trading equities. The ultra-high leverage of the forex market means that huge gains can quickly turn to damaging losses and can wipe out the majority of your account in a matter of minutes. This is important for all new traders to understand, because in the forex market - due to the large amount of money involved and the number of players - traders will react quickly to information released into the market, leading to sharp moves in the price of the currency pair.

Though currencies don't tend to move as sharply as equities on a percentage basis (where a company's stock can lose a large portion of its value in a matter of minutes after a bad announcement), it is the leverage in the spot market that creates the volatility. For example, if you are using 100:1 leverage on \$1,000 invested, you control \$100,000 in capital. If you put \$100,000 into a currency and the currency's price moves 1% against you, the value of the capital will have decreased to \$99,000 - a loss of \$1,000, or all of your invested capital, representing a 100% loss. In the equities market, most traders do not use leverage, therefore a 1% loss in the stock's value on a \$1,000 investment, would only mean a loss of \$10. Therefore, it is important to take into account the risks involved in the forex market before diving in.

### **Differences Between Forex and Equities**

A major difference between the forex and equities markets is the number of traded instruments: the forex market has very few compared to the thousands found in the equities market. The majority of forex traders focus their efforts on seven different currency pairs: the four majors, which include (EUR/USD, USD/JPY, GBP/USD, USD/CHF); and the three commodity pairs (USD/CAD, AUD/USD, NZD/USD). All other pairs are just different combinations of the same currencies, otherwise known as cross currencies. This makes currency trading easier to follow because rather than having to cherry-pick between 10,000 stocks to find the best value, all that FX traders need to do is “keep up” on the economic and political news of eight countries.

The equity markets often can hit a lull, resulting in shrinking volumes and activity. As a result, it may be hard to open and close positions when desired. Furthermore, in a declining market, it is only with extreme ingenuity that an equities investor can make a profit. It is difficult to short-sell in the U.S. equities

market because of strict rules and regulations regarding the process. On the other hand, forex offers the opportunity to profit in both rising and declining markets because with each trade, you are buying and selling simultaneously, and short-selling is, therefore, inherent in every transaction. In addition, since the forex market is so liquid, traders are not required to wait for an [uptick](#) before they are allowed to enter into a short position - as they are in the equities market.

Due to the extreme liquidity of the forex market, [margins](#) are low and leverage is high. It just is not possible to find such low margin rates in the equities markets; most margin traders in the equities markets need at least 50% of the value of the investment available as margin, whereas forex traders need as little as 1%. Furthermore, commissions in the equities market are much higher than in the forex market. Traditional brokers ask for commission fees on top of the spread, plus the fees that have to be paid to the exchange. Spot forex brokers take only the spread as their fee for the transaction. (For a more in-depth introduction to currency trading, see [Getting Started in Forex](#) and [A Primer On The Forex Market](#).)

By now you should have a basic understanding of what the forex market is and how it works. In the next section, we'll examine the evolution of the current foreign exchange system.

## History and Market Participants

Given the global nature of the forex market, it is important to first examine and learn some of the important historical events relating to currencies and currency exchange before entering any trades. In this section we'll review the international monetary system and how it has evolved to its current state. We will then take a look at the major players that occupy the forex market - something that is important for all potential forex traders to understand.

### The History of the Forex

#### *Gold Standard System*

The creation of the [gold standard](#) monetary system in 1875 marks one of the most important events in the history of the forex market. Before the gold standard was implemented, countries would commonly use gold and silver as means of international payment. The main issue with using gold and silver for payment is that their value is affected by external supply and demand. For example, the discovery of a new gold mine would drive gold prices down.

The underlying idea behind the gold standard was that governments guaranteed the conversion of currency into a specific amount of gold, and vice versa. In other words, a currency would be backed by gold. Obviously, governments needed a

fairly substantial gold reserve in order to meet the demand for exchanges. During the late nineteenth century, all of the major economic countries had defined an amount of currency to an ounce of gold. Over time, the difference in price of an ounce of gold between two currencies became the exchange rate for those two currencies. This represented the first standardized means of currency exchange in history.

The gold standard eventually broke down during the beginning of World War I. Due to the political tension with Germany, the major European powers felt a need to complete large military projects. The financial burden of these projects was so substantial that there was not enough gold at the time to exchange for all the excess currency that the governments were printing off.

Although the gold standard would make a small comeback during the inter-war years, most countries had dropped it again by the onset of World War II. However, gold never ceased being the ultimate form of monetary value. (For more on this, read [The Gold Standard Revisited](#), [What Is Wrong With Gold?](#) and [Using Technical Analysis In The Gold Markets](#).)

#### *Bretton Woods System*

Before the end of World War II, the Allied nations believed that there would be a need to set up a monetary system in order to fill the void that was left behind when the gold standard system was abandoned. In July 1944, more than 700 representatives from the Allies convened at Bretton Woods, New Hampshire, to deliberate over what would be called the [Bretton Woods system](#) of international monetary management.

To simplify, Bretton Woods led to the formation of the following:

1. A method of fixed exchange rates;
2. The U.S. dollar replacing the gold standard to become a primary reserve currency; and
3. The creation of three international agencies to oversee economic activity: the [International Monetary Fund](#) (IMF), International Bank for Reconstruction and Development, and the General Agreement on Tariffs and Trade (GATT).

One of the main features of Bretton Woods is that the U.S. dollar replaced gold as the main standard of convertibility for the world's currencies; and furthermore, the U.S. dollar became the only currency that would be backed by gold. (This turned out to be the primary reason that Bretton Woods eventually failed.)

Over the next 25 or so years, the U.S. had to run a series of balance of payment

deficits in order to be the world's reserved currency. By the early 1970s, U.S. gold reserves were so depleted that the U.S. treasury did not have enough gold to cover all the U.S. dollars that foreign central banks had in reserve.

Finally, on August 15, 1971, U.S. President Richard Nixon closed the gold window, and the U.S. announced to the world that it would no longer exchange gold for the U.S. dollars that were held in foreign reserves. This event marked the end of Bretton Woods.

Even though Bretton Woods didn't last, it left an important legacy that still has a significant effect on today's international economic climate. This legacy exists in the form of the three international agencies created in the 1940s: the IMF, the International Bank for Reconstruction and Development (now part of the World Bank) and GATT, the precursor to the World Trade Organization. (To learn more about Bretton Wood, read [What Is The International Monetary Fund?](#) and [Floating And Fixed Exchange Rates.](#))

### **Current Exchange System**

After the Bretton Woods system broke down, the world finally accepted the use of floating foreign exchange rates during the Jamaica agreement of 1976. This meant that the use of the gold standard would be permanently abolished. However, this is not to say that governments adopted a pure free-floating exchange rate system. Most governments employ one of the following three exchange rate systems that are still used today:

1. Dollarization;
2. [Pegged](#) rate; and
3. Managed floating rate.

#### *Dollarization*

This event occurs when a country decides not to issue its own currency and adopts a foreign currency as its national currency. Although dollarization usually enables a country to be seen as a more stable place for investment, the drawback is that the country's central bank can no longer print money or make any sort of monetary policy. An example of dollarization is El Salvador's use of the U.S. dollar. (To read more, see [Dollarization Explained.](#))

#### *Pegged Rates*

Pegging occurs when one country directly fixes its exchange rate to a foreign currency so that the country will have somewhat more stability than a normal float. More specifically, pegging allows a country's currency to be exchanged at a fixed rate with a single or a specific basket of foreign currencies. The currency will only fluctuate when the pegged currencies change.

For example, China pegged its yuan to the U.S. dollar at a rate of 8.28 yuan to US\$1, between 1997 and July 21, 2005. The downside to pegging would be that a currency's value is at the mercy of the pegged currency's economic situation. For example, if the U.S. dollar appreciates substantially against all other currencies, the yuan would also appreciate, which may not be what the Chinese central bank wants.

### *Managed Floating Rates*

This type of system is created when a currency's exchange rate is allowed to freely change in value subject to the market forces of supply and demand. However, the government or central bank may intervene to stabilize extreme fluctuations in exchange rates. For example, if a country's currency is depreciating far beyond an acceptable level, the government can raise short-term interest rates. Raising rates should cause the currency to appreciate slightly; but understand that this is a very simplified example. Central banks typically employ a number of tools to manage currency.

### **Market Participants**

Unlike the equity market - where investors often only trade with institutional investors (such as mutual funds) or other individual investors - there are additional participants that trade on the forex market for entirely different reasons than those on the equity market. Therefore, it is important to identify and understand the functions and motivations of the main players of the forex market.

### *Governments and Central Banks*

Arguably, some of the most influential participants involved with currency exchange are the central banks and federal governments. In most countries, the central bank is an extension of the government and conducts its policy in tandem with the government. However, some governments feel that a more independent central bank would be more effective in balancing the goals of curbing inflation and keeping interest rates low, which tends to increase economic growth. Regardless of the degree of independence that a central bank possesses, government representatives typically have regular consultations with central bank representatives to discuss monetary policy. Thus, central banks and governments are usually on the same page when it comes to monetary policy.

Central banks are often involved in manipulating reserve volumes in order to meet certain economic goals. For example, ever since pegging its currency (the yuan) to the U.S. dollar, China has been buying up millions of dollars worth of U.S. treasury bills in order to keep the yuan at its target exchange rate. Central banks use the foreign exchange market to adjust their reserve volumes. With extremely deep pockets, they yield significant influence on the currency markets.

### *Banks and Other Financial Institutions*

In addition to central banks and governments, some of the largest participants involved with forex transactions are banks. Most individuals who need foreign currency for small-scale transactions deal with neighborhood banks. However, individual transactions pale in comparison to the volumes that are traded in the interbank market.

The [interbank market](#) is the market through which large banks transact with each other and determine the currency price that individual traders see on their trading platforms. These banks transact with each other on electronic brokering systems that are based upon credit. Only banks that have credit relationships with each other can engage in transactions. The larger the bank, the more credit relationships it has and the better the pricing it can access for its customers. The smaller the bank, the less credit relationships it has and the lower the priority it has on the pricing scale.

Banks, in general, act as dealers in the sense that they are willing to buy/sell a currency at the bid/ask price. One way that banks make money on the forex market is by exchanging currency at a premium to the price they paid to obtain it. Since the forex market is a decentralized market, it is common to see different banks with slightly different exchange rates for the same currency.

### *Hedgers*

Some of the biggest clients of these banks are businesses that deal with international transactions. Whether a business is selling to an international client or buying from an international supplier, it will need to deal with the volatility of fluctuating currencies.

If there is one thing that management (and shareholders) detests, it is uncertainty. Having to deal with foreign-exchange risk is a big problem for many multinationals. For example, suppose that a German company orders some equipment from a Japanese manufacturer to be paid in yen one year from now. Since the exchange rate can fluctuate wildly over an entire year, the German company has no way of knowing whether it will end up paying more euros at the time of delivery.

One choice that a business can make to reduce the uncertainty of foreign-exchange risk is to go into the [spot market](#) and make an immediate transaction for the foreign currency that they need.

Unfortunately, businesses may not have enough cash on hand to make spot transactions or may not want to hold massive amounts of foreign currency for

long periods of time. Therefore, businesses quite frequently employ hedging strategies in order to lock in a specific exchange rate for the future or to remove all sources of exchange-rate risk for that transaction.

For example, if a European company wants to import steel from the U.S., it would have to pay in U.S. dollars. If the price of the euro falls against the dollar before payment is made, the European company will realize a financial loss. As such, it could enter into a contract that locked in the current exchange rate to eliminate the risk of dealing in U.S. dollars. These contracts could be either forwards or futures contracts.

### *Speculators*

Another class of market participants involved with foreign exchange-related transactions is speculators. Rather than hedging against movement in exchange rates or exchanging currency to fund international transactions, speculators attempt to make money by taking advantage of fluctuating exchange-rate levels.

The most famous of all currency speculators is probably George Soros. The billionaire hedge fund manager is most famous for speculating on the decline of the British pound, a move that earned \$1.1 billion in less than a month. On the other hand, Nick Leeson, a derivatives trader with England's Barings Bank, took speculative positions on futures contracts in yen that resulted in losses amounting to more than \$1.4 billion, which led to the collapse of the company.

Some of the largest and most controversial speculators on the forex market are hedge funds, which are essentially unregulated funds that employ unconventional investment strategies in order to reap large returns. Think of them as mutual funds on steroids. Hedge funds are the favorite whipping boys of many a central banker. Given that they can place such massive bets, they can have a major effect on a country's currency and economy. Some critics blamed hedge funds for the Asian currency crisis of the late 1990s, but others have pointed out that the real problem was the ineptness of Asian central bankers. (For more on hedge funds, see [Introduction To Hedge Funds - Part One](#) and [Part Two](#).) Either way, speculators can have a big sway on the currency markets, particularly big ones.

Now that you have a basic understanding of the forex market, its participants and its history, we can move on to some of the more advanced concepts that will bring you closer to being able to trade within this massive market. The next section will look at the main economic theories that underlie the forex market.

## **Economic Theories and Data**

There is a great deal of academic theory revolving around currencies. While often not applicable directly to day-to-day trading, it is helpful to understand the overarching ideas behind the academic research.

The main economic theories found in the foreign exchange deal with parity conditions. A [parity](#) condition is an economic explanation of the price at which two currencies should be exchanged, based on factors such as inflation and interest rates. The economic theories suggest that when the parity condition does not hold, an arbitrage opportunity exists for market participants. However, arbitrage opportunities, as in many other markets, are quickly discovered and eliminated before even giving the individual investor an opportunity to capitalize on them. Other theories are based on economic factors such as trade, capital flows and the way a country runs its operations. We review each of them briefly below.

### Major Theories: Purchasing Power Parity

[Purchasing Power Parity](#) (PPP) is the economic theory that price levels between two countries should be equivalent to one another after exchange-rate adjustment. The basis of this theory is the law of one price, where the cost of an identical good should be the same around the world. Based on the theory, if there is a large difference in price between two countries for the same product after exchange rate adjustment, an arbitrage opportunity is created, because the product can be obtained from the country that sells it for the lowest price.

The relative version of PPP is as follows:

$$e = \frac{\pi_1 - \pi_2}{1 + \pi_2}$$

Where 'e' represents the rate of change in the exchange rate and ' $\pi_1$ ' and ' $\pi_2$ ' represent the rates of inflation for country 1 and country 2, respectively.

For example, if the inflation rate for country XYZ is 10% and the inflation for country ABC is 5%, then ABC's currency should appreciate 4.76% against that of XYZ.

$$\text{Expected Currency Appreciation} = \frac{\text{XYZ} - \text{ABC}}{1 + \text{ABC}} = \frac{0.10 - 0.05}{1 + 0.05} = \frac{0.05}{1.05} = 4.76\%$$

### Interest Rate Parity

The concept of [Interest Rate Parity](#) (IRP) is similar to PPP, in that it suggests that for there to be no arbitrage opportunities, two assets in two different countries should have similar interest rates, as long as the risk for each is the same. The

basis for this parity is also the law of one price, in that the purchase of one investment asset in one country should yield the same return as the exact same asset in another country; otherwise exchange rates would have to adjust to make up for the difference.

The formula for determining IRP can be found by:

$$(i_1 - i_2) = \left( \frac{F - S}{S} \right) (1 - i_2)$$

Where 'F' represents the forward exchange rate; 'S' represents the spot exchange rate; 'i<sub>1</sub>' represents the interest rate in country 1; and 'i<sub>2</sub>' represents the interest rate in country 2.

### **International Fisher Effect**

The [International Fisher Effect](#) (IFE) theory suggests that the exchange rate between two countries should change by an amount similar to the difference between their nominal interest rates. If the nominal rate in one country is lower than another, the currency of the country with the lower nominal rate should appreciate against the higher rate country by the same amount.

The formula for IFE is as follows:

$$e = \frac{i_1 - i_2}{1 + i_2}$$

Where 'e' represents the rate of change in the exchange rate and 'i<sub>1</sub>' and 'i<sub>2</sub>' represent the rates of inflation for country 1 and country 2, respectively.

### **Balance of Payments Theory**

A country's [balance of payments](#) is comprised of two segments - the [current account](#) and the [capital account](#) - which measure the inflows and outflows of goods and capital for a country. The balance of payments theory looks at the current account, which is the account dealing with trade of tangible goods, to get an idea of exchange-rate directions.

If a country is running a large current account [surplus](#) or [deficit](#), it is a sign that a country's exchange rate is out of equilibrium. To bring the current account back into equilibrium, the exchange rate will need to adjust over time. If a country is running a large deficit (more imports than exports), the domestic currency will depreciate. On the other hand, a surplus would lead to currency appreciation.

The balance of payments identity is found by:

$$BCA + BKA + BRA = 0$$

Where BCA represents the current account balance; BKA represents the capital account balance; and BRA represents the reserves account balance.

### **Real Interest Rate Differentiation Model**

The [Real Interest Rate](#) Differential Model simply suggests that countries with higher real interest rates will see their currencies appreciate against countries with lower interest rates. The reason for this is that investors around the world will move their money to countries with higher real rates to earn higher returns, which bids up the price of the higher real rate currency.

### **Asset Market Model**

The Asset Market Model looks at the inflow of money into a country by foreign investors for the purpose of purchasing assets such as stocks, bonds and other financial instruments. If a country is seeing large inflows by foreign investors, the price of its currency is expected to increase, as the domestic currency needs to be purchased by these foreign investors. This theory considers the capital account of the balance of trade compared to the current account in the prior theory. This model has gained more acceptance as the capital accounts of countries are starting to greatly outpace the current account as international money flow increases.

### **Monetary Model**

The Monetary Model focuses on a country's monetary policy to help determine the exchange rate. A country's monetary policy deals with the money supply of that country, which is determined by both the interest rate set by central banks and the amount of money printed by the treasury. Countries that adopt a monetary policy that rapidly grows its monetary supply will see inflationary pressure due to the increased amount of money in circulation. This leads to a devaluation of the currency.

These economic theories, which are based on assumptions and perfect situations, help to illustrate the basic fundamentals of currencies and how they are impacted by economic factors. However, the fact that there are so many conflicting theories indicates the difficulty in any one of them being 100% accurate in predicting currency fluctuations. Their importance will likely vary by the different market environment, but it is still important to know the fundamental basis behind each of the theories.

### **Economic Data**

Economic theories may move currencies in the long term, but on a shorter-term, day-to-day or week-to-week basis, economic data has a more significant impact.

It is often said the biggest companies in the world are actually countries and that their currency is essentially shares in that country. Economic data, such as the latest gross domestic product (GDP) numbers, are often considered to be like a company's latest earnings data. In the same way that financial news and current events can affect a company's stock price, news and information about a country can have a major impact on the direction of that country's currency. Changes in interest rates, inflation, unemployment, consumer confidence, GDP, political stability etc. can all lead to extremely large gains/losses depending on the nature of the announcement and the current state of the country.

The number of economic announcements made each day from around the world can be intimidating, but as one spends more time learning about the forex market it becomes clear which announcements have the greatest influence. Listed below are a number of economic indicators that are generally considered to have the greatest influence - regardless of which country the announcement comes from.

### *Employment Data*

Most countries release data about the number of people that currently are employed within that economy. In the U.S., this data is known as non-farm payrolls and is released the first Friday of the month by the Bureau of Labor Statistics. In most cases, strong increases in employment signal that a country enjoys a prosperous economy, while decreases are a sign of potential contraction. If a country has gone recently through economic troubles, strong employment data could send the currency higher because it is a sign of economic health and recovery. On the other hand, high employment can also lead to inflation, so this data could send the currency downward. In other words, economic data and the movement of currency will often depend on the circumstances that exist when the data is released.

### *Interest Rates*

As was seen with some of the economic theories, interest rates are a major focus in the forex market. The most focus by market participants, in terms of interest rates, is placed on the country's central bank changes of its bank rate, which is used to adjust monetary supply and institute the country's monetary policy. In the U.S., the Federal Open Market Committee (FOMC) determines the bank rate, or the rate at which commercial banks can borrow and lend to the U.S. Treasury. The FOMC meets eight times a year to make decisions on whether to raise, lower or leave the bank rate the same; and each meeting, along with the minutes, is a point of focus. (For more on central banks read [Get to Know the Major Central Banks.](#))

### *Inflation*

Inflation data measures the increases and decreases of price levels over a period

of time. Due to the sheer amount of goods and services within an economy, a basket of goods and services is used to measure changes in prices. Price increases are a sign of inflation, which suggests that the country will see its currency depreciate. In the U.S., inflation data is shown in the Consumer Price Index, which is released on a monthly basis by the Bureau of Labor Statistics.

### *Gross Domestic Product*

The gross domestic product of a country is a measure of all of the finished goods and services that a country generated during a given period. The GDP calculation is split into four categories: private consumption, government spending, business spending and total net exports. GDP is considered the best overall measure of the health of a country's economy, with GDP increases signaling economic growth. The healthier a country's economy is, the more attractive it is to foreign investors, which in turn can often lead to increases in the value of its currency, as money moves into the country. In the U.S., this data is released by the Bureau of Economic Analysis once a month in the third or fourth quarter of the month.

### *Retail Sales*

Retail sales data measures the amount of sales that retailers make during the period, reflecting consumer spending. The measure itself doesn't look at all stores, but, similar to GDP, uses a group of stores of varying types to get an idea of consumer spending. This measure also gives market participants an idea of the strength of the economy, where increased spending signals a strong economy. In the U.S., the Department of Commerce releases data on retail sales around the middle of the month.

### *Durable Goods*

The data for durable goods (those with a lifespan of more than three years) measures the amount of manufactured goods that are ordered, shipped and unfilled for the time period. These goods include such things as cars and appliances, giving economists an idea of the amount of individual spending on these longer-term goods, along with an idea of the health of the factory sector. This measure again gives market participants insight into the health of the economy, with data being released around the 26th of the month by the Department of Commerce.

### *Trade and Capital Flows*

Interactions between countries create huge monetary flows that can have a substantial impact on the value of currencies. As was mentioned before, a country that imports far more than it exports could see its currency decline due to its need to sell its own currency to purchase the currency of the exporting nation. Furthermore, increased investments in a country can lead to substantial

increases in the value of its currency.

Trade flow data looks at the difference between a country's imports and exports, with a trade deficit occurring when imports are greater than exports. In the U.S., the Commerce Department releases balance of trade data on a monthly basis, which shows the amount of goods and services that the U.S. exported and imported during the past month. Capital flow data looks at the difference in the amount of currency being brought in through investment and/or exports to currency being sold for foreign investments and/or imports. A country that is seeing a lot of foreign investment, where outsiders are purchasing domestic assets such as stocks or real estate, will generally have a capital flow surplus.

Balance of payments data is the combined total of a country's trade and capital flow over a period of time. The balance of payments is split into three categories: the current account, the capital account and the financial account. The current account looks at the flow of goods and services between countries. The capital account looks at the exchange of money between countries for the purpose of purchasing capital assets. The financial account looks at the monetary flow between countries for investment purposes.

#### *Macroeconomic and Geopolitical Events*

The biggest changes in the forex often come from macroeconomic and geopolitical events such as wars, elections, monetary policy changes and financial crises. These events have the ability to change or reshape the country, including its fundamentals. For example, wars can put a huge economic strain on a country and greatly increase the volatility in a region, which could impact the value of its currency. It is important to keep up to date on these macroeconomic and geopolitical events.

There is so much data that is released in the forex market that it can be very difficult for the average individual to know which data to follow. Despite this, it is important to know what news releases will affect the currencies you trade. (For more insight, check out [Trading On News Releases](#) and [Economic Indicators To Know](#).)

Now that you know a little more about what drives the market, we will look next at the two main trading strategies used by traders in the forex market – fundamental and technical analysis.

## **Fundamental Trading Strategies**

In the equities market, [fundamental analysis](#) looks to measure a company's true value and to base investments upon this type of calculation. To some extent, the

same is done in the forex, where fundamental traders evaluate currencies, and their countries, like companies and use economic data to gain an idea of the currency's true value.

All of the news reports, economic data and political events that come out about a country are similar to news that comes out about a stock in that it is used by investors to gain an idea of value. This value changes over time due to many factors, including economic growth and financial strength. Fundamental traders look at all of this information to evaluate a country's currency.

Given that there are practically unlimited fundamental trading strategies based on fundamental data, one could write a book on this subject. To give you a better idea of a tangible trading opportunity, let's go over one of the most well-known situations, the [carry trade](#). (To read some frequently asked questions about currency trading, see [Common Questions About Currency Trading](#).)

### **A Breakdown of the Carry Trade**

The carry trade is a strategy in which a trader sells a currency that is offering lower interest rates and purchases a currency that offers a higher interest rate. In other words, you borrow at a low rate, and then lend at a higher rate. The trader using the strategy captures the difference between the two rates. When highly leveraging the trade, even a small difference between two rates can make the trade highly profitable. Along with capturing the rate difference, investors also will often see the value of the higher currency rise as money flows into the higher-yielding currency, which bids up its value.

Real-life examples of a carry trade can be found starting in 1999, when Japan decreased its interest rates to almost zero. Investors would capitalize upon these lower interest rates and borrow a large sum of Japanese yen. The borrowed yen is then converted into U.S. dollars, which are used to buy U.S. Treasury bonds with yields and coupons at around 4.5-5%. Since the Japanese interest rate was essentially zero, the investor would be paying next to nothing to borrow the Japanese yen and earn almost all the yield on his or her U.S. Treasury bonds. But with leverage, you can greatly increase the return.

For example, 10 times leverage would create a return of 30% on a 3% yield. If you have \$1,000 in your account and have access to 10 times leverage, you will control \$10,000. If you implement the carry trade from the example above, you will earn 3% per year. At the end of the year, your \$10,000 investment would equal \$10,300, or a \$300 gain. Because you only invested \$1,000 of your own money, your real return would be 30% ( $\$300/\$1,000$ ). However this strategy only works if the [currency pair's](#) value remains unchanged or [appreciates](#). Therefore, most carry traders look not only to earn the interest rate differential, but also

capital appreciation. While we've greatly simplified this transaction, the key thing to remember here is that a small difference in interest rates can result in huge gains when leverage is applied. Most currency brokers require a minimum margin to earn interest for carry trades.

However, this transaction is complicated by changes to the exchange rate between the two countries. If the lower-yielding currency appreciates against the higher-yielding currency, the gain earned between the two yields could be eliminated. The major reason that this can happen is that the risks of the higher-yielding currency are too much for investors, so they choose to invest in the lower-yielding, safer currency. Because carry trades are longer term in nature, they are susceptible to a variety of changes over time, such as rising rates in the lower-yielding currency, which attracts more investors and can lead to currency appreciation, diminishing the returns of the carry trade. This makes the future direction of the currency pair just as important as the interest rate differential itself. (To read more about currency pairs, see [Using Currency Correlations To Your Advantage](#), [Making Sense Of The Euro/Swiss Franc Relationship](#) and [Forces Behind Exchange Rates](#).)

To clarify this further, imagine that the interest rate in the U.S. was 5%, while the same interest rate in Russia was 10%, providing a carry trade opportunity for traders to [short](#) the U.S. dollar and to [long](#) the Russian ruble. Assume the trader borrows \$1,000 US at 5% for a year and converts it into Russian rubles at a rate of 25 USD/RUB (25,000 rubles), investing the proceeds for a year. Assuming no currency changes, the 25,000 rubles grows to 27,500 and, if converted back to U.S. dollars, will be worth \$1,100 US. But because the trader borrowed \$1,000 US at 5%, he or she owes \$1,050 US, making the net proceeds of the trade only \$50.

However, imagine that there was another crisis in Russia, such as the one that was seen in 1998 when the Russian government defaulted on its debt and there was large currency devaluation in Russia as market participants sold off their Russian currency positions. If, at the end of the year the exchange rate was 50 USD/RUB, your 27,500 rubles would now convert into only \$550 US (27,500 RUB x 0.02 RUB/USD). Because the trader owes \$1,050 US, he or she will have lost a significant percentage of the original investment on this carry trade because of the currency's fluctuation - even though the interest rates in Russia were higher than the U.S.

Another good example of a fundamental trade is based on commodity prices. (To read more about this, see [Commodity Prices And Currency Movements](#).)

You should now have an idea of some of the basic economic and fundamental

ideas that underlie the forex and impact the movement of currencies. The most important thing that should be taken away from this section is that currencies and countries, like companies, are constantly changing in value based on fundamental factors such as economic growth and interest rates. You should also, based on the economic theories mentioned above, have an idea how certain economic factors impact a country's currency. We will now move on to [technical analysis](#), the other school of analysis that can be used to pick trades in the forex market.

## Technical Analysis

One of the underlying tenets of [technical analysis](#) is that historical price action predicts future price action. Since the forex is a 24-hour market, there tends to be a large amount of data that can be used to gauge future price activity, thereby increasing the statistical significance of the forecast. This makes it the perfect market for traders that use technical tools, such as trends, charts and indicators. (To learn more, see [Introduction to Technical Analysis](#) and [Charting Your Way To Better Returns](#).)

It is important to note that, in general, the interpretation of technical analysis remains the same regardless of the asset being monitored. There are literally hundreds of books dedicated to this field of study, but in this tutorial we will only touch on the basics of why technical analysis is such a popular tool in the forex market.

As the specific techniques of technical analysis are discussed in other tutorials, we will focus on the more forex-specific aspects of technical analysis.

### Technical Analysis Discounts Everything - Especially in Forex

#### *Minimal Rate Inconsistency*

There are many large players in the forex market, such as hedge funds and large banks, that all have advanced computer systems to constantly monitor any inconsistencies between the different currency pairs. Given these programs, it is rare to see any major inconsistency last longer than a matter of seconds. Many traders turn to technical analysis because it presumes that all the factors that influence a price - economic, political, social and psychological - have already been factored into the current exchange rate by the market. With so many investors and so much money exchanging hands each day, the trend and flow of capital is what becomes important, rather than attempting to identify a mispriced rate.

#### *Trend or Range*

One of the greatest goals of technical traders in the FX market is to determine

whether a given pair will trend in a certain direction, or if it will travel sideways and remain range-bound. The most common method to determine these characteristics is to draw trend lines that connect historical levels that have prevented a rate from heading higher or lower. These levels of support and resistance are used by technical traders to determine whether or not the given trend, or lack of trend, will continue.

Generally, the major pairs - such as the EUR/USD, USD/JPY, USD/CHF and GBP/USD - have shown the greatest characteristics of trend, while the currency pairs that have historically shown a higher probability of becoming range-bound have been the currency crosses (pairs not involving the U.S. dollar). The two charts below show the strong trending nature of USD/JPY in contrast to the range-bound nature of EUR/CHF. It is important for every trader to be aware of the characteristics of trend and range, because they will not only affect what pairs are traded, but also what type of strategy should be used. (To learn more about this subject, see [Trading Trend Or Range?](#))



Graph created by E-Signal.

Figure 1



Graph created by E-Signal.

Figure 2

### *Common Indicators*

Technical traders use many different indicators in combination with support and resistance to aid them in predicting the future direction of exchange rates. Again, learning how to interpret various technical indicators is a study unto itself and goes beyond the scope of this tutorial. If you wish to learn more about this subject, we suggest you read our technical analysis tutorial.

A few indicators that we feel we should mention, due to their popularity, are: Bollinger bands, Fibonacci retracement, moving averages, moving average convergence divergence (MACD) and stochastics. These technical tools are rarely used by themselves to generate signals, but rather in conjunction with other indicators and chart patterns.

For more on technical analysis and the forex, take a look at the following articles: [Using Bollinger Band "Bands" To Gauge Trends](#), [Trading Double Tops And Double Bottoms](#), [Introducing The Bearish Diamond Formation](#), [Keep An Eye On Momentum](#) and [Consolidation - Trade The Calm, Profit From The Storm](#).

## **Ready To Trade?**

So, you think you are ready to trade? Make sure you read this section to learn how you can go about setting up an account to trade in the forex along with what

factors you should be aware of *before* you take this step. We will then discuss how to trade and the different types of orders that can be placed.

### **Opening A Forex Brokerage Account**

Trading the forex is similar to the equity market because individuals interested in trading need to open up an account. Like the equity market, each forex account and the services it provides differ, so it is important that you find the right one. Below we will talk about some of the factors that should be considered when selecting a forex account.

#### *Leverage*

**Leverage** is basically the ability to control large amounts of capital, using very little of your own capital; the higher the leverage, the higher the level of risk. The amount of leverage on an account differs depending on the account itself, but most use a factor of at least 50:1, with some being as high as 250:1. A leverage factor of 50:1 means that for every dollar you have in your account you control up to \$50. For example, if a trader has \$1,000 in his or her account, the broker will lend that person \$50,000 to trade in the market. This leverage also makes your margin, or the amount you have to have in the account to trade a certain amount, very low. In equities, margin is usually at least 50%, while the leverage of 50:1 is equivalent to 2%.

Leverage is seen as a major benefit of the forex, as it allows you to make large gains with a small investment. However, leverage can also be an extreme negative if a trade moves against you because your losses also are amplified by the leverage. With this kind of leverage, there is the real possibility that you can lose more than you invested - although most firms have protective stops preventing an account from going negative. For this reason, it is vital that you remember this when opening an account and that when you determine your desired leverage you understand the risks involved.

#### *Commissions and Fees*

Another major benefit of forex accounts is that trading within them is done on a commission-free basis. This is unlike equity accounts, in which you pay the broker a fee for each trade. The reason for this is that you are dealing directly with market makers and do not have to go through other parties like brokers.

This may sound too good to be true, but rest assured that market makers are still making money each time you trade. Remember the bid and ask from the previous section? Each time a trade is made, it is the market makers that capture the spread between these two. Therefore, if the bid/ask for a currency is 1.5200/50, the market maker captures the difference (50 basis points).

If you are planning on opening a forex account, it is important to know that each firm has different spreads on currency pairs traded through them. While they will often differ by only a few [pips](#) (0.0001), this can be meaningful if you trade a lot over time. So when opening an account make sure to find out the pip spread that it has on currency pairs you are looking to trade.

### *Other Factors*

There are a lot of differences between each forex firm and the accounts they offer, so it is important to review each before making a commitment. Each company will offer different levels of services and programs along with fees above and beyond actual trading costs. Also, due to the less regulated nature of the forex market, it is important to go with a reputable company. (For more information on what to look for when opening an account, read [Wading Into The Currency Market](#). If you are not ready to open a "real money" account but want to try your hand at forex trading, read [Demo Before You Dive In.](#))

### **How to Trade**

Now that you know some important factors to be aware of when opening a forex account, we will take a look at what exactly you can trade within that account. The two main ways to trade the currency market is the simple buying and selling of currency pairs, where you go long one currency and short another. The second way is through the purchasing of derivatives that track the movements of a specific currency pair. Both of these techniques are highly similar to techniques in the equities market. The most common way is to simply buy and sell currency pairs, much in the same way most individuals buy and sell stocks. In this case, you are hoping the value of the pair itself changes in a favorable manner. If you go long a currency pair, you are hoping that the value of the pair increases. For example, let's say that you took a long position in the USD/CAD pair - you will make money if the value of this pair goes up, and lose money if it falls. This pair rises when the U.S. dollar increases in value against the Canadian dollar, so it is a bet on the U.S. dollar.

The other option is to use derivative products, such as options and futures, to profit from changes in the value of currencies. If you buy an option on a currency pair, you are gaining the right to purchase a currency pair at a set rate before a set point in time. A futures contract, on the other hand, creates the obligation to buy the currency at a set point in time. Both of these trading techniques are usually only used by more advanced traders, but it is important to at least be familiar with them. (For more on this, try [Getting Started in Forex Options](#) and our tutorials, [Option Spread Strategies](#) and [Options Basics Tutorial](#).)

### *Types of Orders*

A trader looking to open a new position will likely use either a [market order](#) or a

[limit order](#). The incorporation of these order types remains the same as when they are used in the equity markets. A market order gives a trader the ability to obtain the asset at whatever price it is currently trading at in the market, while a limit order allows the trader to specify a certain entry price. (For a brief refresher of these orders, see [The Basics of Order Entry](#).)

For traders that already hold an open position, a [take-profit order](#) can be used to lock in profit. Say, for example, that a trader is confident that the GBP/USD rate will reach 1.7800, but is not as sure that the rate could climb any higher. A trader could use a take-profit order, which would automatically close his or her position when the rate reaches 1.7800, locking in their profits.

Another tool that can be used when traders hold open positions is the [stop-loss order](#). This order allows traders to determine how much the rate can decline before the position is closed and further losses are accumulated. Therefore, if the GBP/USD rate begins to drop, an investor can place a stop-loss that will [close the position](#) (for example at 1.7787), in order to prevent any further losses.

As you can see, the type of orders that you can enter in your forex account are similar to those found in equity accounts. Having a good understanding of these orders is critical before placing your first trade.

If you want to read more, see these frequently asked questions [How does the forex market trade 24 hours a day?](#), [Why is currency always quoted in pairs?](#) and [What is the value of one pip and why are they different between currency pairs?](#)

## Conclusion

While this tutorial only represents a fraction of all there is to know about forex, we hope that you've gained some insight into this topic. We also encourage those of you who are interested in potentially trading in the forex market to learn more about the complexities and intricacies that make this market unique.

Let's recap:

- The [forex market](#) represents the electronic [over-the-counter markets](#) where currencies are traded worldwide 24 hours a day, five and a half days a week. The typical means of trading forex are on the [spot](#), [futures](#) and [forward](#)s markets.
- Currencies are "priced" in [currency pairs](#) and are quoted either [directly](#) or [indirectly](#).
- Currencies typically have two prices: [bid](#) (the amount that the market will buy the quote currency for in relation to the base currency); and [ask](#) (the

- amount the market will sell one unit of the base currency for in relation to the quote currency). The bid price is always smaller than the ask price.
- Unlike conventional [equity](#) and [debt](#) markets, forex investors have access to large amounts of [leverage](#), which allows substantial positions to be taken without making a large initial investment.
  - The adoption and elimination of several global currency systems over time led to the formation of the present currency exchange system, in which most countries use some measure of floating exchange rates.
  - Governments, central banks, banks and other financial institutions, [hedgers](#), and [speculators](#) are the main players in the forex market.
  - The main economic theories found in the foreign exchange deal with parity conditions such as those involving [interest rates](#) and [inflation](#). Overall, a country's qualitative and quantitative factors are seen as large influences on its currency in the forex market.
  - [Fundamental analysis](#) forex traders view currencies and their countries like companies, thereby using economic data to gain an idea of the currency's true value.
  - [Technical analysis](#) forex traders look at currencies no differently than any other asset and, therefore, use technical tools such as trends, charts and indicators in their trading strategies.
  - Unlike stock trades, forex trades have minimal commissions and related fees. But new traders should take a conservative approach and use orders, such as the [take-profit](#) or [stop-loss](#), to minimize losses.