Introduction to the foreign exchange market

Violeta, Gaucan

Journal of Knowledge Management, Economics and Information Technology

15 December 2010

INTRODUCTION TO THE FOREIGN EXCHANGE MARKET

Violeta Gaucan, Titu Maiorescu University, Bucharest, Romania

Abstract: *Before I'll describe forex market I'd like to say why I have choose this subject for this article. First of all I really think that still exist people which don't know about this activity and I strongly believe that in our days it's a must, especially for those people how want to double or triple their profits from their own business. This article was created from a collection of structured data and I wish that through this article to familiarize yourself, more with the currency market.*

Keywords: *forex market, forex currency trading, analysis, psychology*

Personally, like many others I was also mistaken that it is a business only for banks. I was surprised when a friend of mine told me that this business is not only for banks and companies. He was into this business and told me that is earning good money.Latter when logged on to my computer and searched for forex I was nearly shocked to see that 30% of forex industry was held by the individuals. 30% of $7 million industry means a big amount. I further searched about this forex market and got to know that it is online business now. It means anyone can be a forex trader while sitting at home in front of computer. Apparently forex market doesn't have any common points with what we study in school but to a closer look I can say that in forex market we can find informatical, economic, marketing, mathematical, psychological and even geographical elements.

What is forex market? History of the forex market

Foreign exchange dates back to ancient times, when traders first began exchanging coins from different countries. However, the foreign exchange it self is the newest of the financial markets. In the last hundred years, the foreign exchange has undergone some dramatic transformations. The Bretton Woods Agreement, set up in 1944, remained intact until the early 1970s. Trading volume has increased rapidly over time, especially after exchange rates were allowed to float freely in 1971. In 1971, the Bretton Woods Agreement was first tested because of uncontrollable currency rate fluctuations, by 1973 the gold standard was abandoned by president Richard Nixon, currencies where finally allowed to float freely. Thereafter, the foreign exchange market quickly established itself as the financial market. Before the year 1998, the foreign exchange market was only available to larger entities trading currencies for commercial and investment purposes through banks, now online currency trading platforms and the internet allow smaller financial institutions and retail investors access a similar level of liquidity as the major foreign exchange banks, by offering a gateway to the primary (Interbank) market. The FOREX refers to the Foreign Currency Exchange Market in which over 4,600 International Banks and millions of small and large speculators participate worldwide. Every day this worldwide market exchanges more than $1.7 trillion in dozens of different currencies. With the current growth rate the market is projected to grow to more than $1.9 trillion per day by the year 2006. With such volume, one can assume that the forex market is extremely volatile, changing at a moment's notice, depending on conditions within that country.

Forex Exchange Compared to Other Finacial Markets

So, what is forex trading market, really? The answers are simple – and complex. Here, we will go over the basics so that you, the reader, can decide if you wish to learn more. The basic concept behind the foreign exchange (or forex) market is for trading currencies, one pair against another. It's the world's largest market, consisting of almost $2 trillion in daily volume and is growing rapidly.

The value of one currency is determined by its comparison to another currency via the exchange rate. The major currencies traded most often in the foreign exchange market are the euro (EUR), United States dollar (USD), Japanese yen (JPY), British pound (GBP) and the Swiss franc (CHF). These combine to form the most commonly traded currency pairs:

- EUR/USD
- USD/JPY
- GBP/USD
- USD/CHF

The first currency of a currency pair is the *base* currency; the second currency in the pair is the *counter* currency. One can think of currency pairs as a single unit. When buying a currency pair, the base currency is being bought, while the counter currency is being sold. The opposite is true when selling a currency pair.

Foreign currency trading is conducted without a central exchange, but instead is traded over-the-counter (OTC). Unlike other markets, this decentralization allows traders to choose from a large number of different dealers or brokers with which to place trades. This also provides the means to compare prices and pip spreads before buying or selling.

A number of tools and charts are used in forex currency trading and the educated trader uses these tools extensively to perform accurate analysis to determine whether to buy or sell a given currency pair.

The forex market is operated in Europe, Asia and the United States in overlapping shifts, so currencies are constantly traded 24 hours a day. No single entity has the capability of influencing the market – at least for very long. Currency trading – at its most basic definition – is the act of buying and selling (trading) different currencies of the world.

A typical scenario might go something like this: A trader is looking at the British pound (GBP) and U.S. dollar (USD). This is called a currency pair. The GBP is the base currency, and the USD is the secondary currency. News that the value of the GBP is up from previous reports creates a positive reaction and a spike in the value of the GBP. This, in turn, will cause a rally on the GBP/USD currency pair. If the opposite occurred, and a positive announcement for the USD was reported, then the GBP/USD currency pair will fall, or dip. Either scenario can offer up a profit, depending on which part of the currency pair is bought or sold. The price of each currency within the pair is determined by a number of factors, such as changes in political leadership, economic booms or busts, even natural disasters.

Figure 1: How much value each market

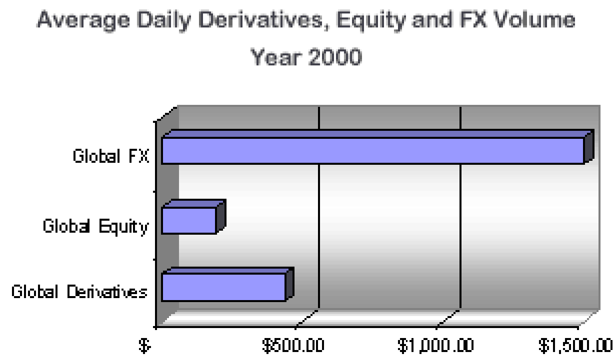

Figure 2: Average daily derivates, equity and Forex volume. Year 2000

Forex Myths

Myths, rumors and legends are everywhere. The forex market is not immune. The new forex trader is likely to be inundated with a number of forex myths, legends and downright falsehoods, so it's important to separate fact from fiction before your money leaves your hands. Here is a list of just a few:

Myth 1 - Forex can make you rich quick

Think about forex as a journey, and not a destination. There is no final winning trade; no huge gains; no trade of the century. Advanced strategies like margin trading, options and futures require a great deal of analysis. Traders make money in the forex market by analyzing trends and making smart decisions. The gain on each trade is a small step in the direction of his or her long-term goals.

Myth 2 – The forex market is rigged

Sometimes you might hear a trader complaining that the market is against them. Every trade they make is a losing one. They blame the broker, the interbank, the government, the timing. The truth is this: foreign exchange rates change often and are too volatile to be rigged. Forex trading is not for the faint-hearted. Blaming everyone but yourself for bad trades will prevent you from learning and growing as a trader. The only person responsible for your poor trade performance is you.

Myth 3 – The markets move in a predictable, scientific way

The junk emails you get from companies trying to sell their guaranteed, scientific formulas are just that – junk. Anyone who tries to tell you that they have the market cornered with forex predictions or a single formula is just as crazy as those people who tell you that you can win the lottery by scientific method. Try doing some paper trading (simulated, such as with a demo) and find the pattern. It's not there.

Myth 4 – The experts know best (experts always win)

This is probably the most enduring myth. Tons of 'experts' abound with advice for the new trader, based on years of experience. News flash: even the world's best traders are right only about half of the time. Think about it – a trader can literally be a loser 50 percent of the time and still be considered an expert in forex

Forex trading systems

A forex trading system is a tool used by traders to help automate the more mundane and intricate aspects of trading. There are hundreds of forex software programs out there and in order to find the best program, you need to do many things. Also called forex robots (or bots), these trading systems offer the trader a variety of automatic functions. Some are fully-featured platforms; others are bare bones robots. There are literally hundreds of forex trading systems out there – enough to confuse the most savvy trader. The poor newbie could go into vapor lock trying to evaluate automated forex trading software without a little help. We have listed a few of the more comprehensive and popular programs available for easy, automated systems trading. No guarantees here, and of course, your mileage may vary.

1) FAPTurbo

FAPTurbo is one of the most popular forex bots, and the website boasts examples of real trading results with real deposits with high-profile brokerages. Fully automated, FAPTurbo is able to automate high-volume trade with tight stop loss routines, which minimize losses. Multiple currencies trading capability enables the trader to diversify. Short-term scalping strategy and safe filters help to maximize control. A Virtual Private Server (VPS) service is offered for a fee.

2) Forex Megadroid

Forex Megadroid is a very popular robot that was completed and used by the developers for a number of years before its release in March of 2009. This is unusual, as many bot systems are on the market as soon as the last line of code is written. Forex Megadroid has an extremely robust interface, and the makers claim that it won't fold under high-volatility conditions like some bots. Forex Megadroid offers a 60-day money-back guarantee, tutorials, 24-hour phone and online support.

3) U$DBot

The makers of U$DBot say that their aim is to take as much of the guesswork out of forex trading as possible. U$DBot is offered at a price somewhat less than other competitors and includes a 60-day money-back guarantee if not satisfied. If the user decides a strategy is not working, the program allows for switching on the fly, making this one of the most versatile forex robots on the market.

4) Forex Auto Pilot System (FAPS)

Developed by forex guru Marcus Leary, FAPS is designed to continuously monitor the forex market unaided, choosing and trading the most profitable transactions based on meticulously written algorithms. Clear and concise feedback by the program lets the trader know exactly what is taking place. The program offers a demo to test the program out before buying.

Understanding Forex Trading

When you are trading Forex you are trading one currency against another. An example would be when you are trading your Dollars for Euros. Most people have experienced this when visiting another country with a different currency. Because the rate for which you can trade your money fluctuates over time, it is also possible to earn money with currency trading. The only rule you have to follow says 'buy low, sell high'. Of course this is not as easy as it sounds as you never know in advance what would be considered 'low' and 'high'. However, if you know which factors influence the rate of a currency, you can make predictions about the future rate of this currency. An important aspect to know when trading is called the 'spread' of the currency. This is the difference between the rate to buy and the rate to sell the currency. This is expressed in 'pips', which is the smallest unit of price of a currency: 0.0001 of a currency unit. For example:

Tabel 1: The Bid/Ask of the EUR/USD

	Bid	Ask
EUR/USD	1.3507	1.3512

In this case the spread is 5 pips (1.3512 – 1.3507 = 0.0005). This means that if you want to buy US Dollars with Euros, you will receive $1.3507. In case you immediately trade this back for Euros you will only receive €0.9996. In this case you lost €0.0004 by only changing from one currency to another and back. This is why a low spread is important when trading, to make sure your money will not all get lost just by trading.

Predicting the Forex market

The Forex market is very complicated and affected by many factors. Nevertheless, the price is always a result of all supply and demand forces. The demand and supply is influenced by several elements which can be put into three categories:

1. Economic Factors

This means the economic conditions and economic policy of a currency zone. The economic policy includes fiscal policy and monetary policy. The economic conditions consist of government budget deficits or surpluses, balance of trade levels and trends, inflation levels and trends and economic growth and health.

2. Political Conditions

This influence can be seen very strong during election time. Also in political unstable countries this is a major influence on the currency price.

3. Market Psychology

This is a major influence in day trading. Currency speculators immediately react to the announcement of a specific economic number. This often results in a market being 'oversold' or 'overbough'.

Methods of Forecasting the Behavior of the Forex Market

Trying to predict a market is a complex exercise and requires the use a scientific basis rather than guesswork to predict Forex market behavior. Primarily, there are 2 methods for predicting Forex market trends:

- Technical Analysis
- Fundamental Analysis

Let's try and understand how these two approaches work:

Fundamental Analysis

Every nation has it's central bank which is responsible for the well being of the economy. Central banks watch some economic factors that affect the economy and adjust their economic policy accordingly. These factors are announced regularly and the exact time of the announcement is known in advance. These factors are the fundamental indicators of the economy. The most important central banks are FED of USA, ECB of European Union, BOJ of Japan and BOE of United Kingdom. There are many fundamental indicators but there are few of them that are called the "market movers". They are called so because when they are announced they provide to the market the necessary steam to move. That happens because they have a great impact on economy and to traders' positions also.

As I say earlier fundamentals are important economic indicators that influence the direction of the market. Forex fundamentals are thus important economic numbers that represent the state of the economy of a certain country/region and therefore the underlying currency. There are thousands of fundamentals but most of them have very limited influence. For instance, typically, when a Fundamental analyst is asked to predict the Forex market rates, would look at existing and expected interest rates, GDP growth rates, inflationary trends, weather changes affecting agricultural output, international trade balances, exchange rate policies of the countries involved, capital market status etc. before saying, "I believe given these indicators, the Forex market ought to be behaving in this way" and would conclude whether a currency is likely to appreciate or depreciate *vis-a-vis* the other one.

Tabel 2: International Interest Rates

Central Bank	Currency	Symbol	Change Date	Interest Rate	Previous Rate
The Reserve Bank of Australia	Australian Dollar	AUD	11/02/2010	4.75%	4.50%
Bank of Canada	Canadian Dollar	CAD	09/08/2010	1.00%	0.75%
European Central Bank	Euro	EUR	05/07/2009	1.00%	1.25%
Bank of England	British pound	GBP	03/05/2009	7.00%	7.00%
Bank of Japan	Japanese yen	JPY	10/05/2010	0.00%	0.10%
Swiss National Bank	Swiss franc	CHF	03/12/2008	0.25%	0.50%
Federal Reserve	U.S. dollar	USD	12/16/2008	0.25%	1.00%
National Bank of Denmark	Danish krone	DKK	01/14/2010	1.05%	1.15%
Hungarian National Bank	Hungarian forint	HUF	04/26/2010	5.25%	5.50%
Bank of Israel	Israeli shekel	ILS	09/27/2010	2.00%	1.75%
Bank of Mexico	Mexican peso	MXN	07/17/2009	4.50%	4.75%
Reserve Bank of New Zealand	New Zealand dollar	NZD	07/29/2010	3.00%	2.75%
Bank of Norway	Norwegian krone	NOK	05/05/2010	2.00%	1.75%
National Bank of Poland	Polish zloty	PLN	06/24/2009	3.50%	3.75%
South African Reserve Bank	South African rand	ZAR	11/18/2010	5.50%	6.00%
Bank of Sweden	Swedish krona	SEK	10/26/2010	1.00%	0.75%
Central Bank of the Republic of Turkey	Turkish lira	TRY	11/19/2009	6.50%	6.75%

Let's analize some of this indicators:

1) Interest Rate(IR)

Every currency zone has an interest rate that is set by the central bank. This rate is the most influential number for the forex market. Higher rates makes it more attractive to possess a certain currency. The interest rate is a reflection of all other economic indicators. View a list of the interest rate of every major central bank.This is how it looks the worldwide IR.

2) The Gross Domestic Product (GDP)

The GDP is an indicator that values the total market value of all goods and services produced in a country during a year.
This makes it the broadest measure of the state of an economy. The Foreign Exchange (Forex) market is the biggest market on earth today. It has a daily turnover of more than 2.5 trillion US$, which is more than 100 times greater than the NASDAQ. The Forex market is traded 24 hours a day, Monday to Friday. The market consists of trading between large banks, central banks, currency speculators, multinational corporations, governments and other financial markets and institutions.

3) Industrial Production

The Industrial Production indicator measures the change in production of a nation's factories, mines and utilities. The report also covers the capacity utilizations. It is important as production reacts quickly to the economic state of a nation.

4) Consumer Price Index (CPI)

The CPI is derived from a basket of products over 200 categories. It signals inflation risks and will therefore influence central banks policy concern.

5) Discover the News Impact on Forex Market. Retail Sales

The Retail Sales indicator measures the total amount spent in retail stores throughout a country. It is an important fundamental because it signals consumer spending which accounts for a majority of overall economic activity. Understanding the main aspects of the Fundamentals will help us to gain a bigger picture understanding of how these factors shape and influence the actions of willing buyers and sellers. Personally, I do not base my trading decisions on the economic factors alone, but that does not mean that I choose to ignore the fundamentals altogether either.It can be of great benefit to any market professional to understand such things and why certain markets have positive and negative correlations with others and why certain news releases have a greater impact on prices than others.Always use some kind of economic calendar before placing your trades – I call this looking left and right before you cross the street. By far, it's better to be safe than sorry.

Technical Analysis

The Technical analysis method focuses on understanding the prevailing market trends and tries to pinpoint any reversal of this trend and predict how the Forex market is likely to behave in the future. It is more statistical in nature in the sense that this method relies heavily on historical data of prices and volumes traded using charts to understand and interpret the market's behavior. There are many mathematical tools available for making such analysis like various indicators, Number Theory, waves, gaps and trends etc. Technical indicators for Technical Analysis help us in analyzing the following:

Identification of the trend for the currency pair

Whether the trend for the currency pair is bullish (uptrend) or bearish (downtrend). Or the currency pair is running sideways (range movement).

Strength of the trend for the currency pair

If there is a trend (up or down) then whether the trend has strength to continue or it's weak, which may indicate that a correction or reversal may take place soon.

Resistance and Support levels

If the currency pair price is falling then at what levels we can expect support and expect a reversal to upward movement. And If the currency pair is having an uptrend then at what levels we can expect resistance and can expect a reversal to downward movement. For example let's suppose a currency pair is having a trend (up or down) and the trend slows down. Our analysis says that the trend should continue but a correction in opposite direction may take place... but to what level? Technical analysis indicators like Fibonacci retracements indicates the possible retracement levels during a reversal or price correction during a trend.There are too many technical analysis indicators available with various online Forex trading platforms. Many theories exist and you will probably be familiar with Gann, Elliot wave and Fibonacci and many traders use them but there not scientific.
We prefer to use a few popular ones. Let's have an overview of some of those:

SAR (Stop and Reversal)

To determine whether a trend is ending and/or a new trend may start.

Bollinger Bands

To measure market's volatility.
To Give buying /selling signals during non-trending /sideways market.
To Have an idea when the market may enter into a trend while running sideways.

MACD (Moving Average Convergence Divergence)

Identification of a new trend.

Figure 3: Boolinger bands

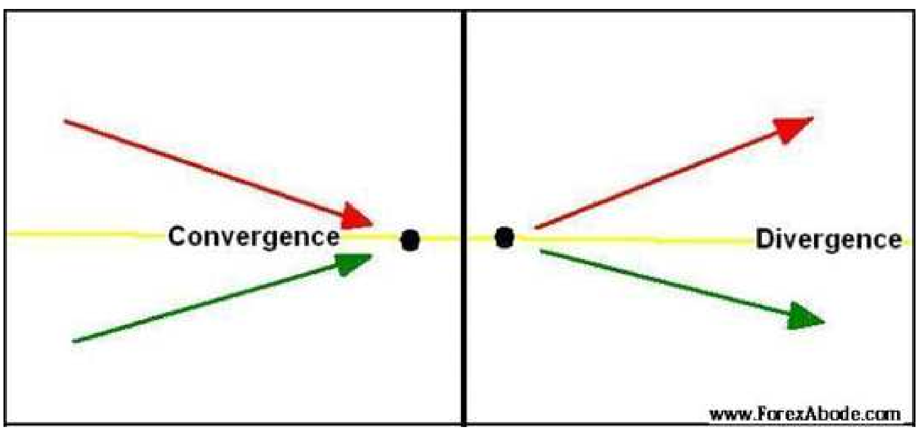

Figure 4: MACD

Stochastic Oscillators

To identify where a trend might be slowing / ending and/or a new trend may start (indicating over bought/over sold levels).

RSI (Relative Strength Index)

To identify whether a trend might be ending and/or a new trend may start (over bought /over sold levels).
RSI also can be used to confirm trend formations.

Moving Averages

To know resistance and support in sideways market
To identify trend reversal

ADX (Advance Directional Index)

To know the strength of the trend

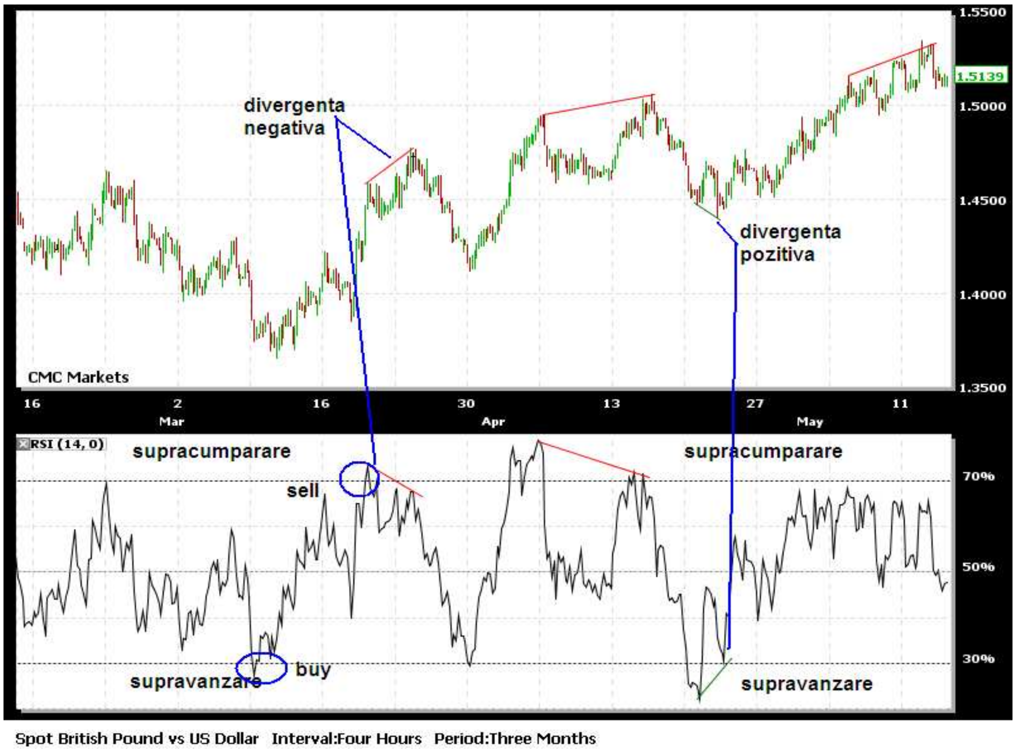

Figure 5: Representation of ADX

Fibonacci Retracements Levels

To know the probable support and resistance levels.

Ichimoku Cloud Charts

Trend Identification. Strength of the trend. Buy and Sell signals and whether the signals are strong or not. Also resistance and support levels.

Technical analysis is underscored by three basic assumptions:

● *The market discounts everything.* That is to say all the happenings in the economy – let's say the global economy – whether they are political events, statements by economic gurus, a security situation, crop failures or the collapse of a bank – everything affects the Forex market and has affected the prices prevailing in the market.

- *Prices move in trends.* This means that there is a pattern to the price movements that needs to be studied. These price movements tell us something about the existing trends and allow us to make predictions.

- *History repeats itself.* Mass thinking does not change dramatically over periods of time and the "wave" of mass psychological thinking moves in a familiar pattern. Only, the same needs to be understood and applied in practice.

The psychology behind trade activity and market psychology

The mental part of trading is just as important as the systems and indicators you utilize. I'll explain here some insights from an excellent book for traders, **Larry Williams'** <u>*Long-Term Secrets to Short-Term Trading*</u>.

Insight 1: "Why do most traders lose most of the time? Markets can spin on a dime and most traders cannot. Even the best traders (or the best trading systems) are going to be frequently wrong. That doesn't negate the trader or the system - that's just part of trading. The challenge for traders is accepting that the trade signal was errant. In a case such as this, Williams correctly points out that we've been trained to 'hang in there' and 'have faith in our initial insight', even if it's clearly the wrong course of action. That's just our ego needing to be right so badly that it will often ignore the exit signals that warn the trader of the impending problem.

Insight 2: It's not the trade, it's the battle. Too many traders believe that their last trade is a reflection of just how good of a trader they are (but they are the only ones who feel that way about themselves). This boils down to one word - expectation. If you expect to win all the time, or even the vast majority of the time, you're setting yourself up for a lot of heartache. That frustration, though, is the very same force that will truly make your negative perception of yourself a reality. And even a good trade can be damaging if you let it warp your disciplined approach. The fact of the matter is that this is a game of odds, and should be played over a long period of time. Focus on the war - not the battle.

Insight 3: The amount of (or lack of) evidence for a market move does not make the move any more or any less likely. All traders, but especially new traders, have one of two problems. They either buy too soon, or buy too late (and in reality, when it comes down to it, those are the ONLY two problems in). The first problem of buying too soon is a sign of not wanting to miss out of any of a move. Of course, if you jump in and the move never becomes a reality, the trade suffers. The second problem is the opposite - the trader wants to make sure the move is going to happen, so he or she will wait for all the right signals to verify that the move is for real. Of course by that time, most of the move is behind you. While it's easier said than done, one has to find a balance between those two extremes. In this case, the best teacher is experience.

Insight 4: What's the difference between winning traders and losing traders? Well, first, there are a few similarities. Both are completely consumed by the idea of trading. The winners as well as losers have committed to doing this, and have no intention of 'going back'. This same black-and-white mentality was evident in their personal lives too. But what about the differences? Here's what Williams observed: The losing traders have unrealistic expectations about the kind of profits they can make, typically shooting too high. They also debate with themselves before taking a trade, and even dwell on a trade well after it's closed out. But the one big thing Williams noticed about this group was that they paid little attention to money management. To me, the mind is where the biggest battle will ever take place for a trader. In this game, you can easily become your own worst enemy if you don't keep your emotions in check at all times. Some experts would say that after your trading strategy has been defined and the risk management principles are put in place, trading then comes down to as much as 90% psychology. Only we can stick to our plan of action and remain calm, unemotional and patient during the peaks and troughs the markets have to offer.

Risk management and trading plan notion

Trading is not really about making money, but instead it is all about capital preservation. Without money in the account, you can't trade. Always risk small percentages of your account and use decent risk to reward ratios which, in time, will provide you with a buffer to cover the losses that you will endure. Risk rewarding ratios are far more important in the longevity of a trading career than hit rates. I always say to my students that trading is not about how you win, but how you lose. Lose small and win big is the idea and if you are disciplined enough, you can still make good money with as little as a 30% success rate. This is one of the only businesses in the world where we can get paid for being overall losers, but only if strict risk management principles are adhered to at all times. Also someone once said that "A goal without a plan is nothing more than a wish." Never a truer word said in Forex trading. Your trading plan should be written to compliment your personal aims for trading as well your own character and make-up. It should be based on the capital you are working with, the style of trading you are looking to carry out and your own tolerance for risk.

Consistency comes from measurable results and sticking to a detailed plan of action will help a trader to keep track of their performance at all times. Fail to Plan, Plan to Fail... For example: Wall Street (the consistently profitable trader) simply buys at demand (wholesale) levels and sells at supply (retail) levels. For reasons mentioned at the beginning of this piece, the average trader and investor buys at supply levels and sells at demand levels. This is why Wall Street, or the Wall Street mind, has such an easy time gaining profits. Now you can understand exactly where those profits come from. The reason the average investor never considers what I am suggesting in this piece is because they are blinded by the strong illusion that how we buy and sell in the trading and investing markets is somehow different from how we properly buy and sell anything. This illusion and misconception is single-handedly responsible for the massive transfer of accounts from those who are blinded by it, into the accounts of those who understand it. Simply put, how you buy and sell things in every other part of your life, grocery shopping, cars, homes, and so on, is EXACTLY how you should be buying and selling stocks and any other markets you may trade or invest in. There is NO difference in the proper action. Buy low, sell high and begin to smile at your finances just like Wall Street does.

Conclusion

Forex trading can be an extremely profitable venture and a successful forex trader in my opinion is one who learns as much as he or she can about the forex market before ever starting to trade, and continues to study and learn.Also Forex is not for prophets,and before opening a position you have to make a deep research and analize what is happening now on charts to predict what the market

mouvements will be.
I think Forex trading is about taking decisions and to be well informed regarding to what is happening in the market. I hope this was of use to you. If you would like to find out more about forex market you can visit links below or read the books mentioned below.

References:

1) New Jersey, (1980), *Day Trading and Swing Trading the Currency market*, Lien Kathy, ed. Day trading the currency market.
2) Headley, P.H, November 23, 2010, *4 Mental Keys That Help My Trading Performance,* [online], [read in 10 decembrie, 2010], http://www.tradingmarkets.com/.site/stocks/how_to/articles/4-Insights-for-Trading-Success-81382.cfm
3) http://www.forexcurrency.org/forex-articles/fundamentals/world-interest-rate/
4) http://www.forexabode.com/technical-analysis/macd
5) http://www.aboutcurrency.com/articles/fxtechnical/forex_technical.shtml
6) http://www.forexabode.com/technical-analysis

.