# Forex

# Trading & Analysis

## (India and International Markets)

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# Table of Contents

## About the Author

Pravin Khetan is the Director at iPlan Education. He is a B.com and MBA in International Finance from GITAM Institute of Foreign Trade. He has quality experience of training over 6000+ students. Students included working professionals from over 89 top MNCs and top colleges like FMS, BITS-Pilani, IMT and many more. He is also a corporate trainer. He is having over 7 years of experience in equity research, value investing, derivative strategies, commodity and forex pricing. His core expertise is in risk management and price discovery. A dynamic personality, having excellent understanding of behavioral finance, he spends his leisure time as pro-trader and writing to various prominent blogs.

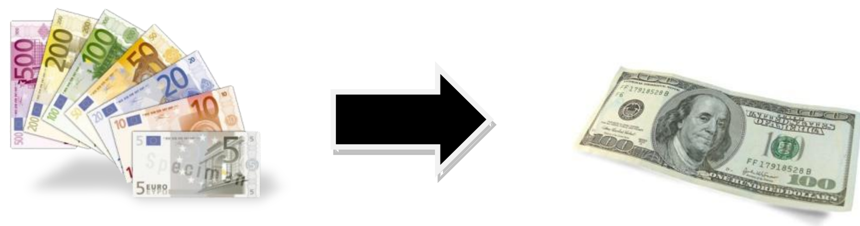
"If past history was all there was to the game, the richest people would be librarians."

~ Warren Buffet

# Chapter 1: Forex Trading Scenario

## What is Forex / FX……….?

**Forex, FX** or **Foreign Exchange** is the process of buying/selling or exchanging one currency with another. These are traded or exchanged through a broker or bank in currency pairs for example the Euro and the US Dollar (EUR/USD) and the Indian Rupee and US Dollar (INR/USD).



### What is Foreign Exchange Market?

The modern foreign exchange market began forming during the 1970s after three decades of government restrictions after world war II (the Bretton Woods system). After that countries gradually switched to floating exchange rates from the previous fixed exchange rate. Currently the Foreign Exchange market is the largest financial market with the average daily turnover of around $5 trillion.

Even the largest stock market in the world, the New York Stock Exchange (NYSE) has an average daily trade volume of about $22 billion.

Major trading participants in this market are central and commercial banks, corporations, institutional investors (FIIs/DIIs), hedge funds and retail investors or private individuals like us.

Although forex trades are carried out all across the world, London has emerged as the biggest geographic trading center and accounts for over 35% of all transactions.

Due to London’s dominance, a particular currency’s quoted price is usually the London market price. Even the International Monetary Fund or IMF calculates the value of its special drawing rights everyday by using the London market price at noon each day. While the main trading centres for forex are New York and London,Tokyo, Hong Kong and Singapore are also important centers

**Remember:**

The currency market is over 200 times bigger! However, here's a catch! This huge $5 trillion trade covers the entire world market. However, retail traders (we) trade in the spot market which is about $1.50 trillion. Also, about 40% of trade volume comes from Forex derivatives. So, no doubt it's bigger than stock market but don't make it a hype.

## Spot Market

The spot market is also known as cash market, in which financial instruments, currency or commodities are traded for immediate delivery. It distinguishes with a futures market in which delivery is made at a later date in future. Usually the delivery of stock is made in T+2 days (Trading +2 days) on various stock exchanges in a cash and carry (CNC) or spot trade.

Normally Spot market can be **Over the Exchange** or **Over-the Counter (OTC)**.

Here, in table 1.1 we can compare the market turnover of various stock exchanges vs. forex market.

| Market | Avg. Daily turnover |
|---|---|
| Forex Spot (retail) | $1.5 trillion |
| Forex spot+derivative (world) | $ 5 trillion |
| New York Stock exchange | $22.5 Billion |
| Tokyo Stock exchange | $19 billion |
| London Stock Exchange | $7.5 Billion |
| NSE, India | $3.5 billion |

*Source: Respective Stock exchanges*

## Trading Over-the-counter (OTC)

In the OTC market, trade is based on contracts made directly between two parties and it is not subjected to the rules of any exchange. The contract terms are agreed between both the parties and it can be non-standard.

In OTC trade the prices are not available publically; it remains between both the parties.

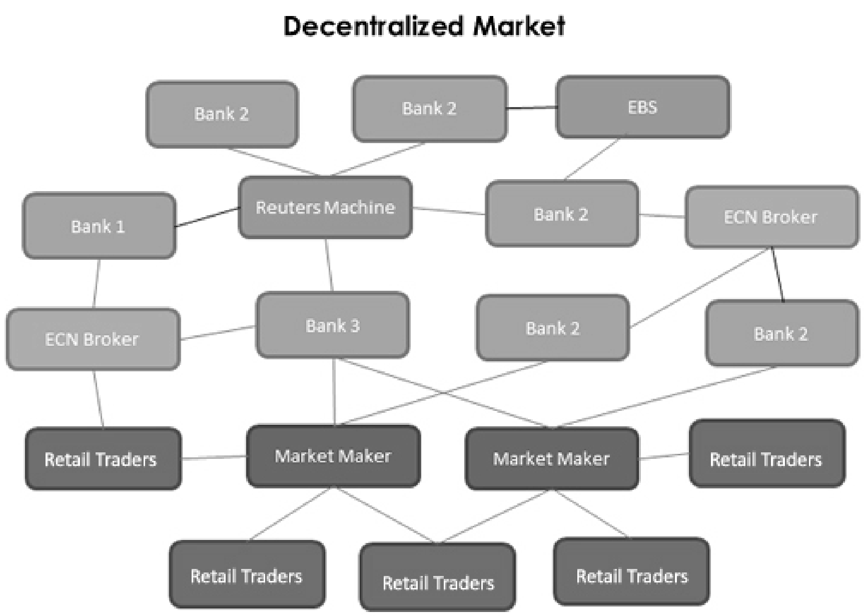
Financial instruments such as govt. bonds and currencies do not trade on a formal exchange and are, therefore, also considered OTC securities. Most debt instruments are traded by investment banks making markets for specific issues. If an investor wants to buy or sell a bond or currency, he or she must call the bank or broker that deals in that bond/currency and asks for quotes.

Note: OTC market exist around us, anything we buy in our day to day life in any near by market of our house can be kind of OTC market. Example: a bank transaction, any commodity purchase.

However, there are organized OTC market also for stock, commodity or any other items. You can find website of these markets.

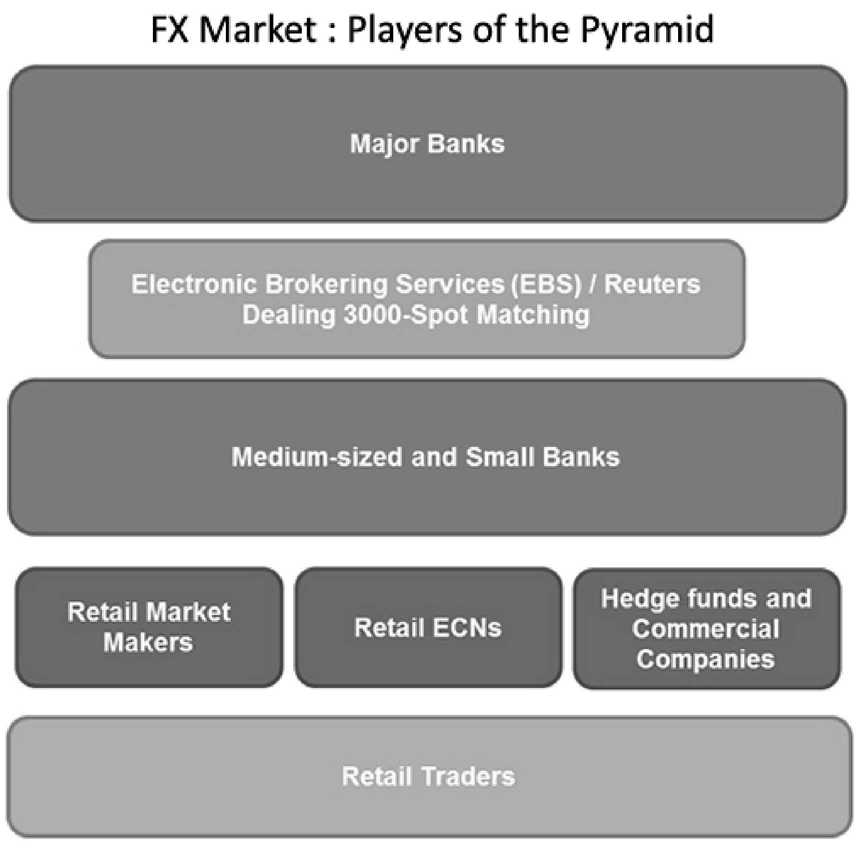
## Trading mechanism

Here, to trade forex you don't need to go through a centralized exchange like the NSE or NYSE with just one pricing. **In the forex market, there is no single price that for a given currency at any time, which means quotes from different currency dealers vary. So, we can say FX market decentralized.**



## Forex Market Players/Participants

We understood that forex market is decentralized. However, we can organize Forex market players in below order. You can see the illustration shown below.




The major trading activity takes place in the interbank market. This is a network of the largest global banks, the participants of this network trade directly with each other over phone or online through the **Electronic Brokering Services (EBS) or the Reuters Dealing 3000-Spot Matching**.

EBS and Reuters 3000 are the world's two top most FX trading service platform provider. They covers almost every major and minor currency pairs. All the banks that are part of the interbank market can see the rates that each other is offering, but this doesn't necessarily mean that anyone can make deals at those prices.

Next on the pyramid are the hedge funds, corporations, companies, retail market makers (dealers) and ECNs. We'll discuss more on Dealers and ECN in later chapters. Their rates are slightly higher and more expensive than those who are part of the interbank market.

Retail traders stay at the foundation of the FX market as end consumer. We actually contribute about one third of total trade turnover. However, we've very less control over the pricing.

### Mechanism of Currency trading through Currency Dealers

Basically, there is no government body controls currency trades. Therefore, the traditional safety nets like centralized exchanges, clearing houses, arbitration boards, do not exist. Currency exchanges are simply made between Forex members based upon the credit arrangements between them.

The main trading centers are New York and London, though Tokyo, Hong Kong and Singapore are all important centers as well. Banks throughout the world participate. Currency trading happens continuously throughout the day; as the Asian trading session ends, the European session begins, followed by the North American session and then back to the Asian session, excluding weekends.

Self-regulation works in currency trading because FX traders all compete and cooperate with one another regularly, improper business practices are discouraged because it is in everyone's best interest to trade fair.

However, a growing number of FX dealers in the United States are opting to join the NFA (National Futures Association). When they join the NFA, dealers agree to abide by any necessary arbitration arising from disputed trades. So if an investor is new to FX, then it is a good idea to seek out only dealers that have opted to become members of the NFA.

## *No commission or brokerage*

There are no charge/brokerage in Forex trading! This is possible because there are no brokers - only FX dealers. So how do the traders make their money?

The dealer pockets the difference between the bid/ask spread. There is a difference between the highest price that an investor is willing to pay when buying and the lowest price another investor is willing to sell for - that difference is the bid/ask spread.

However, the Forex market tends to keep the bid/ask spread exceptionally low because of the high volume of the market itself. In fact, the average bid/ask spread for the entire FX market is less than 1%. For the individual investor, the absence of commissions is usually incentive enough to enter the FX market.