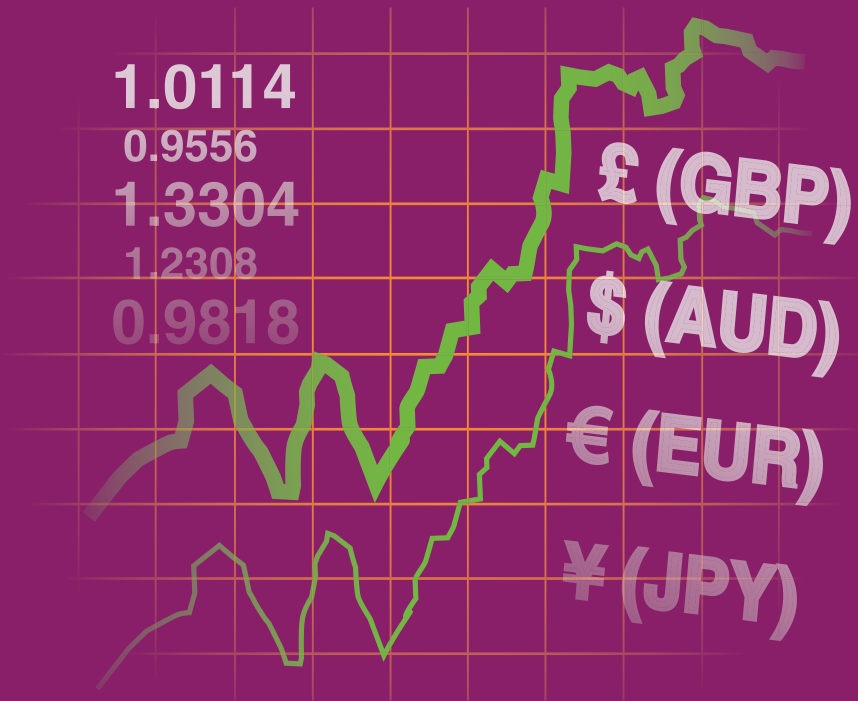
A beginner's guide to foreign exchange success

Forex made simple

SIMPLE, EASY TO UNDERSTAND STRATEGIES ANYONE CAN USE FOR SUCCESS!



Kel Butcher

Author of *20 Most Common Trading Mistakes*

Forex made simple

A beginner's guide to foreign exchange success

Kel Butcher

Wrightbooks

First published 2011 by Wrightbooks
an imprint of John Wiley & Sons Australia, Ltd
42 McDougall Street, Milton Qld 4064

Office also in Melbourne

Typeset in 11.5/13.4 pt Berkeley

National Library of Australia Cataloguing-in-Publication data:

Author:	Butcher, Kel.
Title:	Forex made simple: a beginner's guide to foreign exchange success / Kel Butcher.
ISBN:	9780730375241 (pbk.)
Notes:	Includes index.
Subjects:	Foreign exchange. Foreign exchange market. Foreign exchange futures. Investments—Computer network resources. Electronic trading of securities.
Dewey Number:	332.45

Cover design by Peter Reardon
Pipeline Design <www.pipelinedesign.com.au>

Printed in Australia by Ligare Book Printer

10 9 8 7 6 5 4 3 2 1

Disclaimer
The material in this publication is of the nature of general comment only, and does not represent professional advice. It is not intended to provide specific guidance for particular circumstances and it should not be relied on as the basis for any decision to take action or not take action on any matter which it covers. Readers should obtain professional advice where appropriate, before making any such decision. To the maximum extent permitted by law, the author and publisher disclaim all responsibility and liability to any person, arising directly or indirectly from any person taking or not taking action based upon the information in this publication.

Contents

The secret of success is constancy of purpose.

Benjamin Disraeli

About the author

Kel Butcher is a private trader, entrepreneur and investor. Kel has more than 20 years' experience in financial markets, trading shares, futures, options, warrants and CFDs. He works as a consultant to a managed fund, a boutique trading company and a share-trading software developer. Kel is a regular contributor to *YourTradingEdge* magazine and is the author of *A Step-by-Step Guide to Buying and Selling Shares Online* and *20 Most Common Trading Mistakes and How You Can Avoid Them*. He also featured in *The Wiley Trading Guide*.

Passionate about money management, risk management and position-sizing techniques, Kel acts as a mentor and coach to fellow traders. He can be contacted by email at <kel@tradingwisdom.com.au>.

When he's not trading, Kel enjoys snowboarding, mountain bike riding and surfing. He lives on the NSW Central Coast with his wife Cate and his two sons Jesse and Ollie.

Acknowledgements

My thanks as always go to the staff at Wrightbooks, and in particular Kristen Hammond, for all the help and support in getting this book from concept to book in a short space of time. I would also like to thank FXCM for the use of various screen shots in this book. Glen Larson at Genesis FT deserves special mention for the development of the world's best charting program, Trade Navigator.

I am always honoured to be able to write a book and can't do it without the support of my wife, Cate, and my boys, Jesse and Ollie, and the input and shared experiences of the hundreds of traders and other market participants that I have spoken and corresponded with over many years.

Preface

Derived from the words *foreign* and *exchange*, forex (often abbreviated simply to FX) is the practice of trading currencies or money. The foreign exchange market, also referred to as FOREX, Forex, retail forex, FX, margin FX, spot FX or just ‘spot’, is the largest financial market in the world. Daily trading volumes are approaching US$4 trillion a day—that’s more than three times the total of the world’s stocks and futures markets combined.

The forex market is an over-the-counter (OTC) market. This means that, unlike stock markets and futures markets, there is no central exchange or specific place where trades occur and orders are matched. Instead, forex dealers and market makers are linked around the globe and around the clock by computer and telephone, creating one huge electronic market place.

Once the domain of the large hedge funds, major corporations and international banks, the forex market has become available to retail traders mostly because of the internet, which has allowed the development and evolution of online trading platforms, so that many firms have been able to open up the foreign exchange market to retail clients.

These online platforms not only allow instant execution into the market, but also provide charts and real-time news services. This allows traders to keep abreast of news unfolding around the globe as it happens. The result has been a huge surge in volume of currencies traded as retail clients become aware of the benefits of trading a market that trades virtually continuously from Monday morning Australian time until early Saturday morning Sydney time.

The forex market allows you to actively engage in online trading using broker platforms to buy and sell currencies. The use of leverage when trading in the forex market means that a small amount of money can be used to control much larger positions than would be possible without the use of leverage. But while leverage can help magnify returns, it also magnifies losses when they occur.

Before throwing yourself head first into real money trading you should take the time to familiarise yourself with the principles of foreign exchange trading and ensure you have a full understanding of how it all works. It is also important to understand the evolution of foreign exchange and some of the key milestones in the development of this market into what it is today. So, let's get started.

chapter 1

History of foreign exchange

The roots of modern-day currency trading can be traced back to the Middle Ages when countries with different currencies began to trade with each other. Payments for these transactions were generally made in gold or silver bullion or coins by weight. Transactions were made through money-changers operating in the major trading centres and market places. Their main roles were to weigh the bullion or coins with a degree of precision and to determine the authenticity of the coins being exchanged.

Over time, a system of transferable bills of exchange evolved for use by traders and merchants, reducing the need for them to carry around large amounts of gold or silver bullion or coins.

Introduction of the gold standard

As economies began to expand and international trade grew, so too did the need to make transactions simpler and add stability to the exchange of currencies around the globe. Payments made using gold and silver were not only cumbersome, but were also affected by price changes caused by shifts in supply and demand.

The Bank of England took the first steps to stabilise its country's currency. The Bank Charter Act of 1844 established Bank of England Notes, which were fully backed by gold, as the legal standard for currency.

In 1857, US banks suspended payments in silver, which it had used since the introduction of a silver standard in 1785, as silver had lost much of its appeal as a store of value. This had a disastrous effect on the financial system and is seen by many as a contributing factor to the American Civil War. In 1861 the US government suspended payments in both gold and silver, and began, through the government central bank, a government monopoly on the issue of new banknotes. This gradually began to restore stability to the country's financial system, as the banknotes began to be accepted as a single store of value—unlike the supply of gold and silver, the supply of these notes could be regulated.

Following the American Civil War, as the US economy expanded and international trade increased, there was a dramatic increase in the demand for credit to facilitate trade and finance rapidly expanding world economies.

The main aim of the implementation of the gold standard, whereby currencies are linked to the price of gold, was to guarantee the value of any currency against that of another. Because countries participating in the gold standard maintained a fixed price for gold, currency exchange rates were thus fixed to the gold price. Each country also had to maintain adequate gold reserves to back its currency's value, which provided a high level of stability.

The British pound, for example, was fixed at £4.2472 per ounce of gold (1 ounce is equal to about 28 grams), while the US dollar was fixed at \$20.67 per ounce of gold. So the exchange rate was essentially fixed at US$4.8667 per £1 (US$20.67/£4.2472 = US$4.8667).

Tip

The use of a gold standard to control monetary policy (the use of interest rates to slow or grow an economy) and its impact on inflation, unemployment and economic growth has many economic implications that are beyond the scope of this book.

If the supply of gold remains relatively stable, then so does the supply of money. The use of a gold standard essentially prevents a country from printing too much money, thereby limiting inflation, but at the cost of higher unemployment.

From the perspective of the forex market, the use of a gold standard implies a system of fixed exchange rates between countries. If all countries are on the gold standard, then there is really only one 'real' currency—the price of gold—from which the value of all currencies is determined. The gold standard leads to stability in foreign exchange rates, which is often cited as one of the biggest benefits of using the standard.

The stability that results from use of the gold standard is also one of its biggest drawbacks, because it prevents exchange rates from responding freely to changing circumstances in different countries.

Tip

A gold standard limits the monetary policies a country's central bank can use to stabilise prices and other economic variables, resulting in severe economic shocks.

After a long period of relative stability, the gold standard broke down at the beginning of World War I as the larger European powers were forced to focus their spending on military projects, which led to the printing of excess money. The outbreak of war also interrupted trade flow and the free movement of gold, undermining the ability of the gold standard to function as it should—allowing gold to flow back and forth between countries to ensure a stable currency base.

The gold standard was briefly reinstated between 1925 and 1931 as the Gold Standard Exchange. Facing massive gold and capital outflows as a result of the Great Depression, Britain departed from the gold standard in 1931, and this latest version of the gold standard broke down.

By the mid 1930s London had become the global centre for foreign exchange and the British pound served as the currency both to trade and to keep as a reserve currency. Foreign exchange was originally traded on telex machines, or by cable, earning the pound the nickname *cable*.

Major influences on foreign exchange since World War II

The real growth of the forex market has taken place as a result of events after World War II. The abandonment of the gold standard and the war effort had devastated the British and other European economies. The British pound had also been destabilised by the counterfeiting activities of the Nazis.

In stark contrast to the affects of World War II on the British pound, the US dollar was transformed from a dismal failure after the 1929 stock market collapse, to the leading benchmark currency to which most international currencies were compared. The US economy was on fire. The US emerged as a global economic powerhouse and the US dollar became the pre-eminent global currency.

The Bretton Woods Accord

While the war raged in Europe, representatives of the British and US treasury departments were already planning for postwar economic reconstruction. Central to this was the ability to allow free trade to be conducted without wild currency fluctuations or sudden depreciation, coupled with an effective system of international payments.

During July of 1944 the 44 allied nations met for the United Nations Monetary and Financial Conference at Bretton Woods in the US. The countries agreed to a number of measures designed to stabilise the global economy and currency markets in the aftermath of the war. Chief among these measures was an obligation for each country to adopt a monetary policy that pegged its currency to the US dollar. Each currency was permitted to fluctuate plus or minus 1 per cent from this initial value. When a currency exceeded this range, and at specified predetermined intervention points, the central bank of the country had to either buy or sell the local currency in order to bring it back into the range. This became known as the Bretton Woods system.

As the US dollar was pegged to the value of gold at US$35 per ounce, all currencies were effectively still pegged to the gold price. The US dollar was now assuming the role played by gold under the gold standard. The US dollar became the world's reserve currency.

In order to regulate the member countries' currencies, and to ensure procedures and rules put in place at Bretton Woods were adhered to, the International Monetary Fund (IMF) and International Bank for Reconstruction and Development (IBRD), now the World Bank, were established. The major purpose of the IMF was to maintain a stable system for buying and selling currencies between countries, and to ensure payments for international trade and exchange were conducted in a timely and smooth manner.

The main tasks of the IMF (as noted on its website) were and still are to:

- ⇨ provide a forum for cooperation on international monetary problems
- ⇨ facilitate the growth of international trade, thus promoting job creation, economic growth and poverty reduction
- ⇨ promote exchange rate stability and an open system of international payments
- ⇨ lend countries foreign exchange when needed, on a temporary basis and under adequate safeguards, to help them address balance of payments problems.

The Nixon Shock

The decision now referred to as the Nixon Shock was a series of measures taken by US president Richard Nixon that destroyed the Bretton Woods system and led to the free-floating currency system that exists today.

By 1970 the cost of the Vietnam War and increased domestic spending were causing a rapid rise in inflation in the United States. The US was also running both a balance of payments deficit and a trade deficit, causing other Bretton Woods member countries to become concerned about America's ability to pay its debts. To cover this spending the US was printing excess money, resulting in a dollar glut. In effect the US dollar was over-valued compared with the other currencies that were part of the Bretton Woods Accord.

At the same time, gold was trading at a higher price on the free market than the rate at which it was pegged against the US dollar. This allowed traders to make an arbitrage play by buying pegged gold with US dollars and selling it at the higher prices prevailing in the free market. This combination of events saw government gold coverage of the US dollar decline from around 56 per cent to less than 25 per cent. When the US lifted its quota on the import of oil, this also triggered further massive dollar outflows from the US economy.

In May 1971 West Germany, fearful of building inflationary pressures in both the German and global economies as a result of the US trade and balance of payments deficit, became the first member country to opt out of the Bretton Woods system, and the value of the US dollar declined by 7.5 per cent against the German (Deutsche) mark. During this period France accumulated almost US$200 million worth of gold, and Switzerland US$50 million of gold, further depleting US gold reserves. In early August 1971, as the US Congress recommended devaluation of the US dollar to protect it from what they referred to as foreign price gougers, Switzerland also withdrew from the Bretton Woods system.

On 15 August 1971 President Richard Nixon announced measures to combat the rampant inflation in the US and stabilise the economy. These included a 90-day price and wages freeze, a 10 per cent import surcharge, and the cancellation of the convertibility of US dollars to gold. These decisions were made without consultation with the other members of the Bretton Woods system, and became known as the Nixon Shock.

Tip

From a foreign exchange trading perspective, the dropping of the gold standard led to the free floating of most major world currencies and opened up the global financial markets.

The Smithsonian Agreement

Despite abandoning the Bretton Woods system, Nixon was still uncertain that the free market could allow a true and fair representation of a currency's value. Like many at the time, he was concerned that an entirely unregulated foreign exchange market could lead to currency devaluations and the breakdown of international trade.

In December 1971 the G10 (Group of 10) countries agreed under the terms of the Smithsonian Agreement to maintain fixed exchange rates without the backing of gold. The G10 countries are Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States. The US dollar was also to be allowed to float within a 2.25 per cent range, instead of just 1 per cent as under the Bretton Woods system. The free market price of gold exploded to more than $215 per ounce and the US trade deficit continued to grow. In light of these issues and a host of others, the foreign exchange markets were closed in February 1972, and the Smithsonian Agreement collapsed. When the forex markets reopened in 1973 the US dollar was not fixed to any underlying value measure and its value was not confined to within any predetermined valuation parameters.

Floating the dollar, coupled with rising oil prices resulting from conflict in the Middle East at the time, created stagflation in the US economy. Stagflation occurs when unemployment and inflation are both high. The result was the introduction of a range of new economic policies in the US that saw confidence return to the US economy.

Free-floating currencies

The death of the Bretton Woods system and the collapse of the Smithsonian Agreement ultimately led to the system of free-floating currencies that exists today. By 1978 the free floating of currencies was mandated by the IMF. By this time, foreign exchange markets had evolved considerably and allowed a laissez-faire approach to international currency trade. The true free-market nature of this market saw liquidity and volumes continue to grow, making foreign exchange trading more appealing for speculators and hedgers, as well as the traditional users of these markets.

A free-floating currency's value is a function of the current supply and demand forces in the market, rather than a synthetic value created by intervention policies. Free-floating currencies can also be traded openly by all market participants and speculators. Free-floating currencies experience the heaviest trading demand. While a free-floating currency is much easier to trade than a regulated or manipulated currency, liquidity is also a major consideration.

Currency reserves

Before the Bretton Woods Accord, the official means of international payment, and thus the official international reserve, was gold. Under the Bretton Woods system the official reserve currency for the global financial system was the US dollar. Between 1944 and 1968 the US dollar could be converted into gold, and from 1968 to 1973 central banks could convert US dollars into gold, but only from their own official gold reserves.

Since the collapse of the Smithsonian Agreement in 1973, no major currencies have been convertible into gold. Instead, countries and large corporations now hold currency reserves. Reserve currencies, or foreign exchange reserves, are simply assets held in various currencies. Foreign exchange reserves are important indicators of the ability to repay foreign debt and for currency defence, and are used to determine the credit ratings of nations. Holding currency reserves in place of gold reserves led to a significant increase in volumes and liquidity in the foreign exchange markets. As countries and large corporations buy and sell currencies in response to constantly changing economic and geo-political events, this adds huge liquidity to the market.

Currently the euro and Japanese yen are also considered safe-haven currencies during periods of instability. The portfolio of reserve currencies a country or financial institution may hold changes depending on international conditions.

The Swiss franc is often included, but at times this can be problematic because the franc has lower levels of liquidity than the US dollar, euro and Japanese yen. The introduction of the euro currency in 1999 has had the biggest influence on the number of US dollars held as reserve currency. Since 1999 the proportion of US dollars held in official reserve currency by central banks and other financial institutions around the world has dropped from just under 71 per cent to slightly more than 62 per cent, while the euro has risen from just under 18 per cent to 27 per cent.

Tip

The US dollar is still the most widely held reserve currency, and it is considered to have reserve-currency status. The US dollar is still considered a safe haven in times of economic uncertainty and global upheaval, because the US is still seen as a safe economy backed by the US Treasury.

The European Community and the introduction of the euro

More recently, the emergence of the euro currency has had a dramatic impact on foreign exchange markets. An understanding of the events leading up to the release of the euro currency is important for understanding the role of the Eurozone in the global economy and the euro currency in global foreign exchange markets.

The European Monetary Union was created as a result of a long and continuous series of efforts after World War II to create closer economic cooperation among the capitalist European countries. The European Community (EC) commission's officially stated goals were to improve inter-European economic cooperation, create a regional area of monetary stability, and act as 'a pole of stability in world currency markets'. The first steps in this rebuilding were taken in 1950, when the European Payment Union was instituted to facilitate the inter-European settlement of international trade transactions. The purpose of the community was to promote inter-European trade in general, and to eliminate restrictions on the trade of coal and raw steel, in particular, as both were in high demand following the war.

The European Economic Community was established in 1957 under the Treaty of Rome. One of its main objectives was to eliminate customs duties and other barriers that hindered free trade and movement between the member nations. At the same time it began to set up trade barriers against non-member nations.

In 1969 a conference of European leaders set the objective of establishing a monetary union within the EC in order to stimulate European trade and bring together the member nations so they could compete successfully with the growing economies of the United States and Japan. The EC aimed to implement a common European currency by 1980.

In 1978 the then nine members of the EC ratified a new plan for stability—the European Monetary System (EMS). This new system, implemented in 1979, employed an exchange rate mechanism (ERM) to encourage participating countries to maintain their currency exchange rates within a defined range. These permissible limits were derived from the European Currency Unit (ECU). The ECU was a basket of currencies of the European Community member states used as the internal accounting unit within the EC and for some large international financial transactions.

In 1988 a three-stage plan was proposed to allow EU members to reach full economic union, to advance social and economic unity within what became known as the Eurozone, and to increase its presence in the global financial arena. Included in this plan was the establishment of the European Central Bank and a single currency to replace existing national currencies, culminating in full convergence in the Economic and Monetary Union (EMU) or European Monetary Union as it is more generally known. The EMU is essentially the agreement among the member nations to adopt a single currency unit and monetary system. These plans were formalised in the Maastricht Treaty in 1992. In 1993 the European Union (EU) was formally established with 15 member nations.

In 1999, more than 40 years after the idea was first proposed, the euro was introduced as an all-European currency by 11 of the then 15 member states. It remained an accounting-only currency until 1 January 2002, when euro notes and coins were issued and individual national currencies, such as the French franc and the German mark, began to be phased out.

As well as its role in helping create a single European market place, the single euro currency has a number of other benefits, which include:

- the elimination of exchange rates and fees within the Eurozone
- price transparency between countries
- ease of travel for citizens, and goods and services across traditional geographic borders
- lower interest rates
- the formation of a liquid and respected international currency that is used by foreign investors and traders
- the creation of a social and political symbol of integration and unity.

The euro is now used by 16 of the 27 EU members and accounts for more than 25 per cent of global currency reserves. The member states that use the euro as their sole currency are referred to as the Eurozone.

Recent growth of foreign exchange markets

In addition to the historical events that led to the development and evolution of global foreign exchange markets, some more recent events have contributed to the explosion in interest in trading foreign exchange not only among large financial institutions and banks, but also at the retail trader level. Foreign exchange trading has experienced spectacular growth in volume since currencies began to free float in 1978. In 1977, when currencies were still regulated, average daily turnover was around US$5 billion. This had increased to US$600 billion in 1987, and reached the US$1 trillion per day mark in September 1992. Average daily turnover in the forex market is now approaching US$4 trillion—a number that dwarfs all other financial markets. Currency volatility and intra-day price moves are the primary drivers of this explosive growth in volume, and they could never have occurred under a regulated environment.

Some of the main developments that have contributed to the growth of this market include interest rate volatility, international business operations, increased international trade and the use of currency hedging, automated dealing systems, and the internet and retail traders.

Interest rate volatility

Economic globalisation and the increased importance and use of monetary policy have had a significant impact on interest rates. Economies have become much more interrelated, exacerbating the need to change interest rates in response to global economic and geo-political events and to changes in economic conditions between trading partners. Interest rates are altered by the central bank in each country to adjust economic growth and to control inflation. Raising interest rates will slow spending and growth, while lowering interest rates generally leads to more spending and higher growth. Interest-rate differentials between countries affect exchange rates.

Tip

A strong economy with low inflation and interest rates that are high relative to the country's trading partners will experience a rise in its currency's value. An economy that is perceived as being weak, and having low interest rates, will usually have a weaker currency.

The movement of money between countries and currencies to take advantage of these interest-rate differentials is a major contributor to both the volume and volatility of currency trades. The process of buying a high-yield currency (one with a high interest rate) and selling a currency with a low yield (one with a low interest rate) is referred to as a carry trade, which will be discussed in detail in chapter 6.

International business operations

Business globalisation and competition have intensified in parallel with economic globalisation as businesses search for new markets for finished goods, as well as cheaper input costs of labour and raw materials. The pace of internationalisation has expanded in recent decades as a result of a number of major events. These include the fall of communism in the Eastern Bloc countries and the Soviet Union, economic crises in South-East Asia and South America, and the rise of both China and India as global economic powerhouses. These events have influenced the demand and supply of both raw materials and finished goods. As a result, the supply and demand of various currencies during these periods is also affected, as wealth and asset protection measures are implemented at both a corporate and government level.