Foreign Exchange (FX) Currency Pairs

Currency Pair Notation

from (http://forextraininggroup.com/an-overview-of-the-major-forex-currency-pairs)

Forex currency pairs are often written by separating the three letter ISO 4217 currency code for each currency by a slash ("/"). For example, EUR/USD is the typical forex market notation for the currency pair consisting of European Union Euros for which the ISO code is EUR being quoted in U.S. Dollar terms for which the ISO code is USD.

Furthermore, each currency pair consists of a base currency that appears before the slash and a counter currency or quote currency that appears after the slash in the common market shorthand.

For the EUR/USD currency pair, the euro or EUR is the base currency in the pair, while the U.S. Dollar or USD is the counter currency in the pair that is being quoted relative to the base currency.

For example, an exchange rate quotation of 1.1500 for the EUR/USD currency pair means that each European Union Euro is worth 1.1500 U.S. Dollars. Hence, 10 million Euros could be exchanged for 11.5

million U.S. Dollars at that exchange rate.

The Pecking Order in Currency Pairs

The prevailing forex market quotation convention gives precedence to certain currencies over others that affects whether they are usually quoted as the base currency or the counter currency in a currency pair.

This established priority ranking or “pecking order” for six of the most commonly traded currencies is as follows:

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EUR > GBP > AUD > NZD > USD > CHF > JPY
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According to this traditional pecking order, the foreign exchange market usually quotes the EUR/GBP and USD/CHF currency pairs in that order, rather than as GBP/EUR or CHF/USD. In the case of the EUR/GBP currency pair, the EUR appears first in the currency pair because it is situated higher in the aforementioned pecking order than the GBP.

Furthermore, most minor currencies are quoted as the counter currency in currency pairs with U.S. Dollars acting as the base currency. Examples are USD/SGD for the U.S. Dollar/Singapore Dollar exchange rate and USD/SEK for the U.S. Dollar Swedish Krona exchange rate.

Liquidity in the Major, Minor and Exotic Currency Pairs

Forex_pairs_LiquidityParticipants in the forex market sometimes differ as to exactly which currency pairs they consider to be major, minor or exotic. Nevertheless, in most cases, these general categories describe currency pairs that respectively tend to be very liquid, quite liquid or relatively illiquid.

Furthermore, in the context of the currency market, the term “liquidity” refers to the degree to which forex market is able to handle a purchase or sale transaction without causing a substantial change in the exchange rate for the currency pair in question.

In practice, forex market liquidity tends to be a function of the number of market markers available to make quotations for a particular currency pair and their readiness to absorb large transactions without moving the exchange rate much.

The forex market for major currencies — such as the EUR, GBP, CHF, JPY, AUD, CAD and NZD — quoted against the USD tends to be very liquid, so the EUR/USD, GBP/USD, USD/CHF, USD/JPY, AUD/USD, USD/CAD and USD/JPY currency pairs are considered by most forex traders to be major currency pairs.

The next lower tier of liquidity is shared by the minor currency pairs, which include the so-called cross currency exchange rates that do not involve the U.S. Dollar. Some traders include the NZD/USD in this classification, while others place it among the major FX pairs since it remains popular among traders and tends to enjoy quite liquid markets as a result.

Traders of cross currency pairs typically experience less liquid trading conditions and wider spreads than those enjoyed for the forex major pairs. Cross exchange rates can be derived from the more liquid markets of their component currencies quoted versus the U.S. Dollar.

Highly liquid examples of cross currency pairs that do not involve the U.S. Dollar include the EUR/JPY, EUR/CHF, EUR/GBP and GBP/JPY currency pairs. Less liquid cross currency pairs include the AUD/JPY and GBP/CAD currency pairs, for example.

Relatively illiquid markets exist for the least liquid tier of currency pairs commonly known as the exotic currency pairs, and dealing spreads can be considerably wider for these pairs as a result. Exotic currency pairs typically consist of the currency of a smaller or emerging economy paired as the counter currency with a major currency like the U.S. Dollar or Euro that acts as the base currency. Examples of exotic currency pairs include: USD/SGD that refers to the U.S. Dollar/Singapore Dollar exchange rate and EUR/TRY that refers to the European Union Euro/Turkish Lira exchange rate.

What Makes A Currency Pair Liquid?

from (http://orderflowforex.com/2011/07/what-makes-a-currency-pair-liquid)

GDP Of The Nations

How big the economy is of the countries is a much better determinant of how liquid a currency pair is. The bigger the GDP of the countries, the more liquid the exchange rate. This answers the question why the EUR/USD is more liquid than the USD/CAD. If you combine the GDP of the eurozone countries, which is around $12 trillion, with the GDP of the United States, which is $15 trillion, you get $27 trillion dollars.

If you combine the GDP of the United States ($15 trillion) with Canada's ($1.6 trillion) you only get $ 16.6 trillion dollars.

Therefore, even though the trade between the United States and Canada is the largest, the EUR/USD exchange rate is far more liquid than USD/CAD, because the economies of the EUR/USD currency pair are much larger.

What this means is that there is a lot more potential for financial capital to flow into and out of the Eurozone and the United States. Money can flow into and out of the debt markets, equity markets, real estate markets, etc of the United States and Eurozone, far more easily than between the United States and Canada.

Spreads

Typically, the most liquid currency pairs will have the lowest spreads in normal market conditions. This is why you will almost always see the EUR/USD have a lower spread than the GBP/USD or the GBP/CHF. There is just a lot more financial flows occurring in EUR/USD than between GBP/USD or GBP/CHF.

Looking at spreads are a quick way to determining whether a currency is liquid or not. For example the USD/JPY spread can be 1 or 2 pips, while the spread in EUR/NZD can be 5-10 pips. Whats much more liquid USD/JPY or EUR/NZD?

USD/JPY obviously.

Don’t always rely on the spread though, as it can deceive you at times. It is possible for the spread in GBP/USD to be temporarily lower than the EUR/USD. There could be market participants temporarily battling each other to provide the best bid/offer, thus reducing the spread in GBP/USD temporarily until those orders are filled. Or it is possible that a news release in the eurozone has temporarily increased the spread in EUR/USD. And it is possible at that moment in time that GBP/USD can be more liquid than EUR/USD. But overall EUR/USD is still more liquid than GBP/USD.

It should also be noted that just because a spread is temporarily low, that doesn’t mean the market is liquid. The spread may be 1 pip in EUR/USD on multiple occasions during the Sydney session, but the market may still be thin. Chewing through the orders at the 1 pip spread can be extremely easy exposing the illiquidity of the currency during such a session.

So a currency pair can absolutely have a tight spread, but have low liquidity as the market is thin.