Basic Terminology of Foreign Exchange

1. Base and Counter Currencies

In stock and bond markets one can sell their security. This means that they can convert their security into money. However, in the Forex market, one is already buying and selling money. So then how does the trading work?

Well, in the Forex markets, one buys and sells currencies simultaneously. This means that one exchanges one form of currency for another. Therefore the prices of currencies are always quoted in pairs. The price signifies the unit of the first currency that one is willing to pay for the second currency. Since the price is always quoted in terms of the first currency, it is referred to as the base currency. The other currency mentioned in the pair is the counter currency.

For example in a USD/EUR pair, the United States Dollar would be referred to as the base currency while the Euro would be called the counter currency.

2. Long and Short Positions

Just like the bond and stock markets, Forex markets also allow traders to take long and short positions. However, the meaning of long and short positions changes in this market. Once again this is because currencies are traded in pair. Hence, new investors get confused what happens when they go long and what does it mean to go short.

In the Forex market going long means that you buy units of the base currency and sell units of the counter currency. When one already has a long position and continues to go long, they are said to be going longer!

For example if you were to go long on the USD/EUR pair, you would have to buy the USD and sell EUR in the market.

Similarly, in the Forex market going short means that you sell units of the base currency while buying units of the counter currency. Adding to the short position is referred to as going shorter

Therefore if you were to go short on the USD/EUR pair, you would have to sell the USD while simultaneously buying the EUR.

Also, going back to a zero position from a long or short position is referred to as squaring off. If you are long, you need to sell to square off whereas if you are short, you need to buy to square off.

3. Bid, Ask and Spread

Forex markets are run by market makers. They provide a two way market for all currencies at all times. Therefore, they provide buy and sell quotes. The price at which they are willing to buy is always less than the price at which they are willing to sell. The difference is meant to compensate them for the risk they are taking by holding a volatile asset for an uncertain period of time.

The price at which they are willing to buy is called the bid price whereas the price at which they are willing to sell is called the ask price. The difference between the two is called the bid ask spread or sometimes it is simply referred to as the "spread".

4. Lots

This term is frequently used when Forex markets derivatives are being traded. Forex market future contracts always have a fixed size. For instance, US dollar contracts may be available in multiples of $5000. Therefore every $5000 contract will be referred to as a lot. Hence, if you wish to buy USD 25,000 in the future, you will have to purchase 5 lots. Different currencies have different lot sizes available. Market makers provide more flexibility to currencies which have higher liquidity.

5. Pip

This is the minimum amount by which the currency quote can move. The usual pip refers to 1/10000 of the quoted currency. This means that a currency must change by at least 0.00001% for there to be an effect on the quoted prices in the Forex markets.

Pips have become a part of the Forex trader lingo. Changes in prices and even profits made are expressed in terms of pips. However, since the pip could refer to a variable amount of money, it takes some experience to understand what is being communicated.

6. Value Dates and Rollovers

Value date is the date at which the parties to the trade agree to settle their accounts. This means that the open positions of all derivative contracts are closed automatically on the value date. Thus contracts become more volatile when they are closer to the value date.

Also, in many cases, traders decide to rollover their contracts. This means that they decide to settle their contracts on the next value date instead of the current value date. In order to do so, both parties must agree and then also there has to be a fees paid based on the interest rate differences of both the currencies.

There are many more terms that are frequently used in the Forex market. However, those terms may refer to strategies used in the market and are therefore beyond the scope of this basic article. To sum it up, Forex trading has its own vocabulary which one must get used to.