Interest Rates and the FX Market

Many FX traders get confused about which fundamental news releases to focus on when making a trading decision. I suggest to these traders to follow news releases that potentially impact the currency's interest rate. This article will explain why the interest rate movements are important to the value of the currency.

Each currency carries with it an interest rate. This is almost like a barometer of that economy's strength or weakness.

As a nation's economy strengthens over time, prices tend to rise as the consumers are able to spend more of their income. The more we make, the better our vacations can be, and the greater amount of goods and services we are able to consume. This creates a loop where more money chases roughly the same amount of goods which can lead to higher prices for those goods. The rise in prices is called inflation.

If inflation is allowed to run rampant, our money will lose much of its buying power, and ordinary items such as a loaf of bread may one day rise to unbelievably high prices such as a hundred dollars per loaf. It sounds like an unlikely far-fetched scenario but this is exactly what occurs in nations with very high inflation rates, such as Zimbabwe. To stop this danger before it emerges the central bank steps in and raises interest rates in order to stem inflationary pressures before they get out of control.

Higher interest rates make borrowed money more expensive, which in turn dissuades consumers from buying new homes, using credit cards, and taking on any additional debts. More expensive money also discourages corporations from expansion, as so much business is done on credit, from which interest is always charged.

Eventually, higher rates will take their toll as economies slow down, until a point where the Central Bank will begin to lower interest rates. This time, the reduction in rates is to encourage economic growth and expansion. The Central Bank has a delicate balance of trying to foster growth while at the same time keeping inflation low.

A side effect of high interest rates is that foreign investors desire to invest in that country. The logic is identical to that behind any investment. The investor seeks the highest returns possible.

By increasing interest rates, the returns available to those who invest in that country increase. Consequently, there is an increased demand for that currency as investors invest where the interest rates are higher.

Countries that offer the highest return on investment through high interest rates, economic growth, and growth in domestic financial markets tend to attract the most foreign capital. If a country's stock market is doing well and they offer a high interest rate, foreign investors are likely to send capital to that country. This increases the demand for the country's currency, and causes the currency's value to rise.

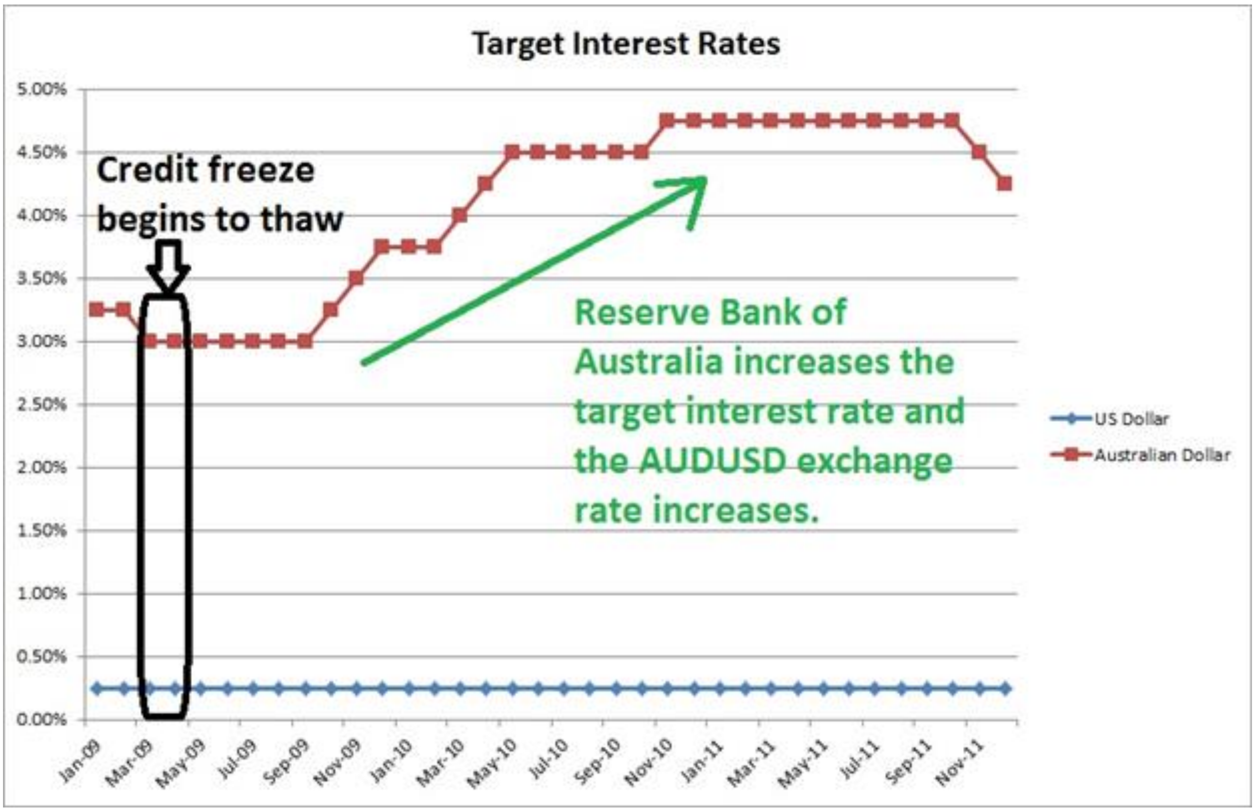
As you can see, it is not just the rate itself that is important. The direction of the interest rate can act as a good proxy for demand for the currency. The direction of the interest rate is obtained through the central bank's language in the statement that accompanying their target rate decision.

The accompanying statement is analyzed word-for-word for any signs of what the central bank may do at the next meeting. *Remember, the interest rate decision itself tends to be less important than the expectations for future interest rate moves.*

High and increasing rates at the beginning of an economic expansion can generate growth and value in a currency. On the other hand, low and lowering rates may represent a country experiencing difficult economic conditions which is reflective in a reduction of the currency value.

The Widening Interest Rate Differential

In early 2009, the worldwide economy was bottoming out as the United States credit freeze began to thaw. The Fed kept U.S. interest rates at all-time lows while the Reserve Bank of Australia began their process of increasing their target benchmark rate.



Since this was in the beginning of an economic expansion, foreign investors into Australian companies needed Australian Dollars to make their investment. Additionally, FX traders began buying the AUDUSD currency pair in anticipation of this demand for the Australian Dollar.

(Created by J. Wagner)

Those traders were rewarded as the AUDUSD exchange rate began a 30 cent rise while earning an additional daily dividend from 2009 through 2011. One mini lot trade of 10,000 units of currency would have yielded over $3,000 plus interest.

Interest Rate Expectations: The Driver of Forex Rates

Talking Points

- **Future interest rate expectations take precedence over the headline rate**
- **If a country has a high interest rate, but no further increases are expected, the currency can still fall.**
- **If a country has a low interest rate but is expected to raise interest rates over time, its currency can still rise**

While it is easy for Forex traders to understand the logic of why investors move money from lower yielding currencies and assets to higher yielding assets and currencies. They may also believe that the simple mechanism of supply and demand is responsible for currency movement. However, this is only part of the story. The expectation of future interest rate increases or rate cuts is even more important than just the actual rates themselves.

Learn Forex: Rate Expectations Sinking GBPUSD

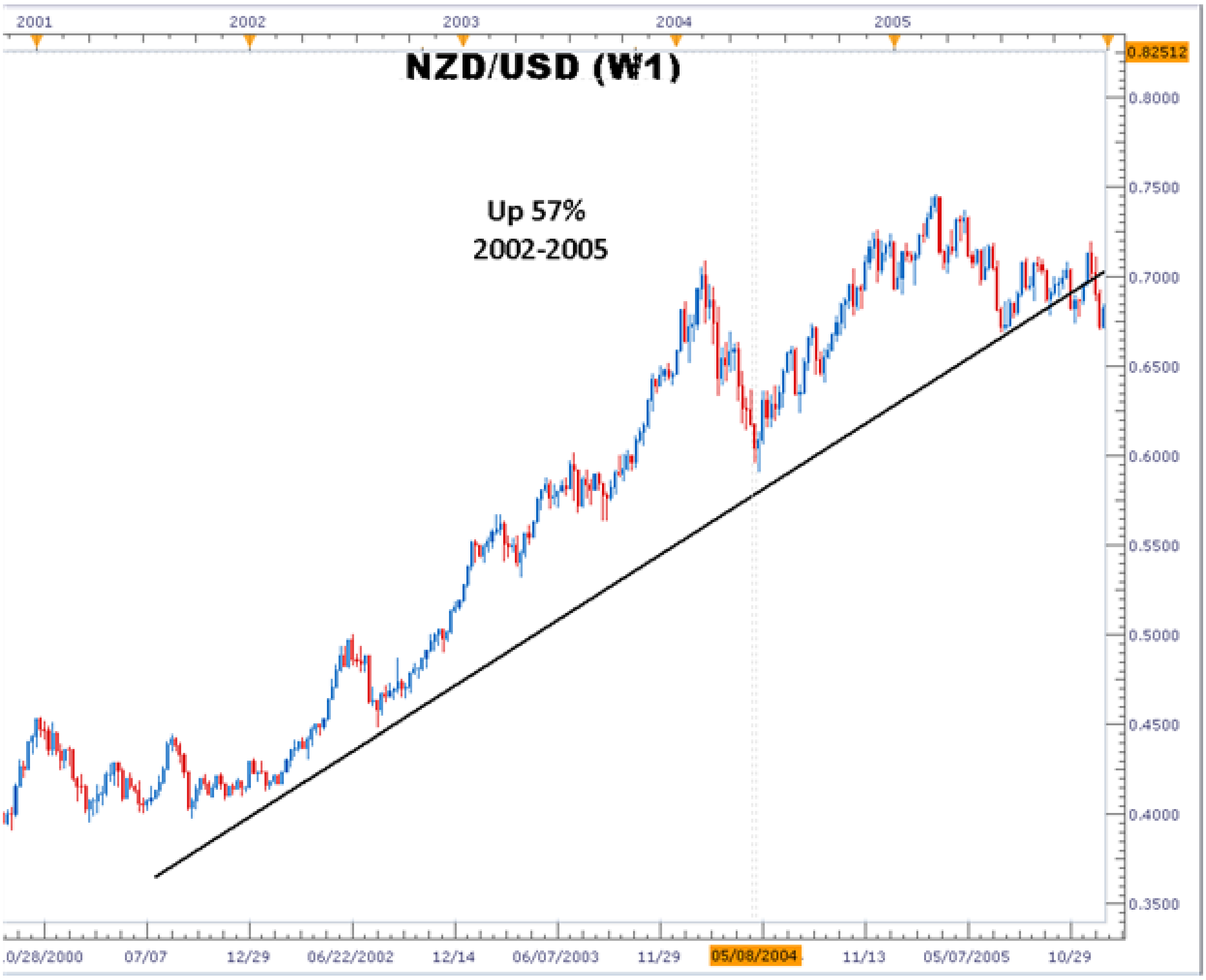
Created by Gregory McLeod

For example, the United Kingdom had interest rates that hovered between 4.5 and 4.75% which was much higher than the 3.25% in the United States. Conventional wisdom would dictate that GBPUSD should have went up during this time period. However, as seen in the chart above, this was clearly not the case as GBPUSD headed lower. The reason for this was the expectations that the US Federal Reserve would begin a rate tightening cycle. The 250 basis point premium enjoyed in the UK at the beginning of 2005 narrowed to just 25 basis point difference. The Fed raised the interest rate from 3.25% in December 2004 to 6.00% by May of 2006.

If a central bank decides to one day, hike rates and then say that they are through raising rates for the foreseeable future, then a currency can still sell off though the interest rate was raised.

On the other hand, if a central bank begins to aggressively raise interest rates to curb inflation and inflation remains stubbornly high, investors around the world realize that there is nowhere for rates to go but up. The currency of that nation may continue to rise as expectations for more rate hikes become widely anticipated.

Learn Forex: NZD/USD Uptrend with Interest Rate Increases



(Created by Gregory McLeod)

In the example above, NZDUSD rose 57% as the Reserve Bank of New Zealand continued to raise rates. From 2002 to 2005 the RBNZ raise interest rates from 4.75% to 7.25% while the Fed increased rates from 1.73% to 4.16% over the same period. Investors in search of higher yields trade the low yielding dollar for the higher yielding NZD. The result was NZDUSD rallying 57%.

If the chances that interest rates can be raised in the future is near zero, investors will want to look elsewhere for a country whose rates are rising. The market is a discounting mechanism which means favorable news, like interest rate hikes are already built into the price. To continue to offer value, there must be an indication that rates will continue to rise to justify the inflated price in the currency. Without any expectations of a rate rise, there is little incentive for new investors to enter or for past investors to remain.

On the other hand, extreme levels of interest rates can shift and move interest rate expectations in the opposite direction because investors believe that interest rates may revert back to the mean. Much like a rubber band stretching to extremes and snaps back, interest rates behave in a similar manner. The extreme interest rates of the 1980’s in the U.S. that topped out at 20% saw a snap back toward 3% in the 1990’s. The extreme low interest rates around the world following the Global Financial Crisis of 2008 may revert back to the mean which is much higher than current 3%. The bottom line is that Forex traders have to not only watch the headline currency rate, but they also have to monitor interest rate expectations in order to keep themselves on the right side of the trade.

How a Currency Can Change the World

One of the most interesting aspects of the Forex market is the global implication carried behind each and every quote.

While a price may move quickly, and at times, feel fleeting; it’s often easy to forget that these prices carry heavy repercussions throughout our economies – even if your nations’ currency isn’t in the quote.

A great example of that is Japan.

Traditionally a heavy exporter, Japan’s economy is very much driven by their trade balance and the world economy continuing to purchase Japanese goods. As Yen gets more expensive compared to other currencies, it makes purchasing those goods more expensive for foreign consumers. This can be extremely prohibitive to the Japanese economy, and the companies that are trying to sell goods to those foreign consumers.

Let’s run through a very basic analogy to see how Japan is affected with a strong Yen by taking a closer look at one of Japan’s key industries and one that many of us are probably already familiar with: The Automotive industry.

Let’s say that one of the large automobile manufacturers in Japan is in the process of expanding into the United States; and has seen business from the United States become an increasingly important part of their growth strategy. If they were only able to sell cars to Japan, they wouldn’t be able to sell enough to recoup all of their overhead expenses, meaning that as a company they would take a loss without their American business; so this strategy of distributing cars to the United States is critical to their continued growth, success, and prosperity as a company.

Let’s assume that in year one, when the exchange rate of the USDJPY was at an even 100.00 level, it cost our fictitious company $20,000 or ¥2,000,000 to produce their base model automobile. This still allowed for them to pay shipping and selling expenses ($5,000 per unit, or ¥500,000 per unit) to get the total cost of the automobile – before being sold, to $25,000 or ¥250,000.

This allows them to sell the car for $30,000 or ¥3,000,000 and garner a profit of $5,000 or ¥500,000 per unit. Each car sold puts $5,000 to their bottom line. The table below walks through this arrangement:

¥100 to $1	$	¥
Cost to Produce Car		2,000,000
Transportation & Shipping		500,000
Total Cost to Produce		2,500,000
Selling Price	$30,000	¥3,000,000
Profit		¥500,000

Let's fast forward a year, and let's say that we've seen the exchange rate move down to ¥75.00 per $1. This means the yen has strengthened 25% and business has just gotten much more difficult for exporters in Japan.

While it cost the same ¥2,000,000 to produce the automobile as last year, and the same ¥500,000 to ship and sell the product; the exchange rate has made a large difference to our company.

If they want to use the same price points as the year before, they may be forced to take a loss. Since the Yen is now more expensive against the dollar, our company will probably be looking at a reduced profit. The below table will walk through a scenario in which we keep the price the same in the face of a strengthening currency.

¥75 to $1	$	¥
Cost to Produce Car		2,000,000
Transportation & Shipping		500,000
Total Cost to Produce		2,500,000
Selling Price	$30,000	¥2,250,000
Profit		(¥250,000)

Notice that while production costs and the selling price remained the same as the year before, the change in the exchange rate means that what was previously a ¥500,000 gain is now a ¥250,000 loss.

A change of ¥750,000 in only one year has taken place for each automobile sold, and this is solely because the Japanese are looking at a more expensive yen.

This can have a grave impact on an economy, particularly one that relies on continually exporting goods.

As you can imagine, this is not a strong business strategy that many Japanese companies are interested in entertaining over the long-term, so it’s time to look at some alternative business strategies.

Let’s say that our company wants to ensure themselves of a profit. So they do the math and they see that they can gleam a profit if they raise the price to $35,000. The table below will illustrate this change in price.

¥75 to $1	$	¥
Cost to Produce Car		2,000,000
Transportation & Shipping		500,000
Total Cost to Produce		2,500,000
Selling Price	$35,000	¥2,625,000
Profit		¥125,000

Raising the price to $35,000 per car means they could possibly profit ¥125,000 per unit. This is half of what the profit was from the year before; but we have to anticipate another effect entering into the equation; and that’s the consumer.

Consumers notice that the same car that cost $30,000 the year before now costs $35,000 – an increase of almost 15%. Now customers are looking at other makes, other models, and any other car where they can get more for their money.

Not only do you, as a company, have to contend with decreasing demand from consumers scared away by higher prices (the term sticker-shock comes to mind); you also have to deal with your own shareholders that are unhappy that profit has decreased so greatly while sales have remained constant.

So while the price of $35,000 might bring the company a profit, it may not be a requisite option as it can upset both consumers, and your own shareholders. So the company explores even higher price points.

A selling price of $40,000 could potentially pacify shareholders, so you entertain that option as well. The table below shows the potential profit margin with a $40,000 selling price.

	$	¥
Cost to Produce Car		2,000,000
Transportation & Shipping		500,000
Total Cost to Produce		2,500,000
Selling Price	$40,000	¥3,000,000
Profit		¥500,000

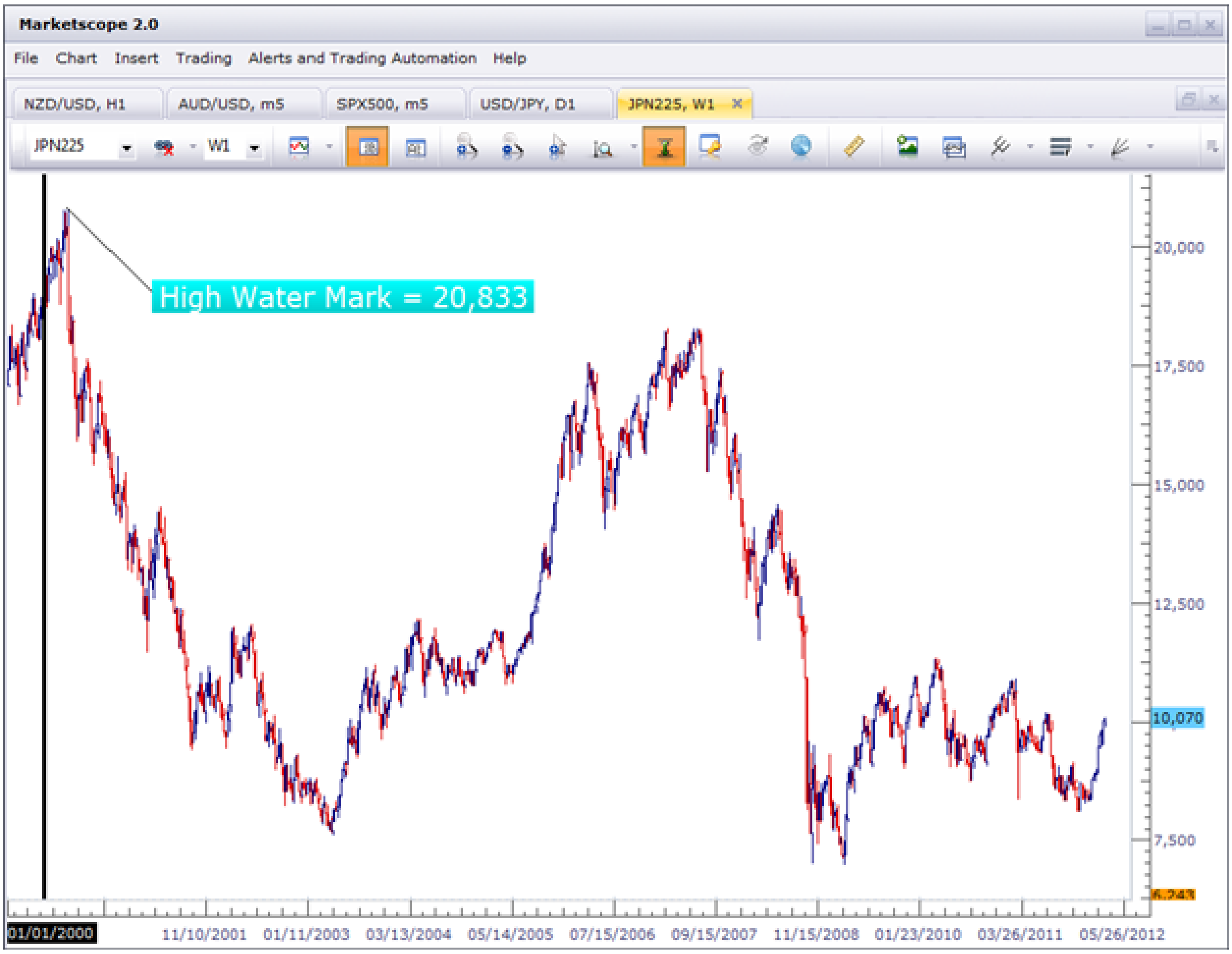
Notice that the profit realized by the company is the same profit realized a year earlier; only we've had to increase the price of the car by 33% to realize the same amount!

The big question is – do you think you would be able to sell the same number of cars for $40,000 that you had for $30,000? What about $35,000?

The answer, most likely, is no.

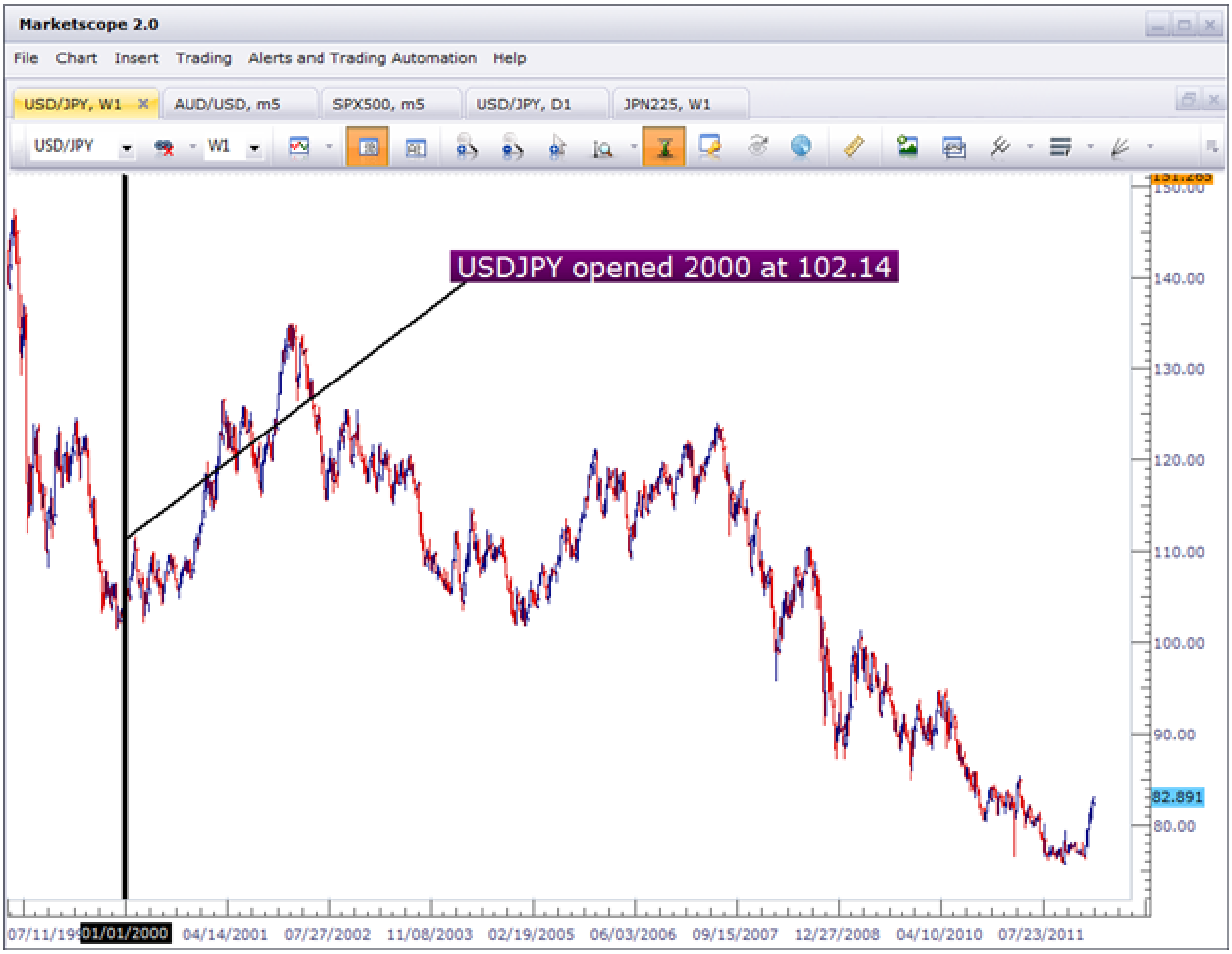
The fact of the matter is that consumers are price conscious, and changes in prices such as what we looked at above, changes of 15% or 30% can often cause consumers to look to other products or manufacturers.

This is one of the primary reasons that Japanese stocks have fared so poorly when their currency has strengthened so much. The below chart illustrates the Japan 225 CFD (based on Japanese stocks) since the opening of the year 2000. In April of 2000, Japanese stocks hit a 'High-Water Mark,' of 20,833 as shown on the chart below:



The above chart shows a stark down-trend, accented by the economic recovery that eventually became the Financial Collapse of 2008. The part that would perplex many traders is to notice the chart of the USDJPY currency pair over the same period.

Keep in mind, as the Yen is the counter-currency in this pair, decreases in price denote strength.



From the above 2 charts, the relationship that becomes clear is that as the Yen has strengthened, we've seen investors selling Japanese stocks.

The big reason that this takes place is because reality isn't nearly as flexible as what we had prescribed in our analogy. Consumers care about prices; and when prices increase they will often look elsewhere to other manufacturers, other products, or other markets to fulfill their needs.

While the economy of Japan holds hope on this most recent rally, it's important to keep in mind the multiplier effect that can be carried by movements in their currency.

If they are able to effectively devalue their currency – they have the luxury of being able to reduce prices and become more competitive; stealing sales away from American and German auto manufacturers. This can lead to increases in corporate profits, which can lead to increases in stock market valuations.

But if they have to stare into the face of a constantly appreciating currency unit, the future is not bright, for Japan or any other export nation.

Trading Forex Using GDP

Talking Points

- **GDP stands for Gross Domestic Product**
- **It measures the economic growth and health of an economy in key areas**
- **Forex traders use GDP as one way of identifying a strong or weak currency.**

Developed in 1934 by Simon Kuznets, the Gross Domestic Product, known commonly by the initials **G.D.P.**, measures the output and production of finished goods in a particular country's economy.

Usually, GDP is measured in three different time periods; monthly, quarterly and annually. This enables economists and traders to get an accurate picture of the overall health of the economy.

There are many approaches to calculating GDP, however, the U.S. Bureau of Economic Analysis uses the Expenditure Approach using the formula **GDP** = Consumption +Investment (I) + Government Spending (G) + (Exports (X)- Imports (M)).

GDP encompasses personal consumption, wholesale inventories, and retail sales. Because each of these components is already measured and released in separate announcements early, GDP is often regarded as “backward looking.” This means that the market may have already priced in GDP based on the other economic releases that make up this number.

The advance release of GDP is four weeks after the quarter ends while the final release happens three months after the quarter ends. Both are released by the Bureau of Economic Analysis (BEA) at 8:30 AM ET.Typically, investors are looking for US GDP to grow between 2.5% to 3.5% per year. Without the specter of inflation in a moderately growing economy, interest rates can be maintained around 3%. However, a reading above 6% GDP would show that the US economy is endanger of overheating which can, in turn, spark inflation fears.

Consequently, the Federal Reserve may have to raise interest rates to curb inflation and put the “brakes” on an overheating economy. Maintaining price stability is one of the jobs of the Federal Reserve. GDP has to stay in a “goldilocks range”; not too hot and not too cold. GDP should not be high enough to trigger inflation or too low where it could lead to recession. A recession is defined by two consecutive negative quarters of GDP growth. The GDP “sweet spot” varies from one country to another. For example, China has had GDP in double digits and 4 or 5% GDP would be unhealthy for that large economy.

Forex traders are most interested in GDP as it is a complete health “report card” for a particular country’s economy. A country is “rewarded” for a high GDP with a higher value of their currency. There is usually a positive expectance for future interest rate hikes because strong economies have a tendency to get stronger creating higher inflation. This, in turn, leads to a central bank raising rates to slow growth and to contain the growing specter of inflation.

On the other hand, a country with weak GDP has a drastically reduced interest rate hike expectations. In fact, the central bank of a country that has two consecutive quarters of negative GDP may even choose to stimulate their economy by cutting interest rates.

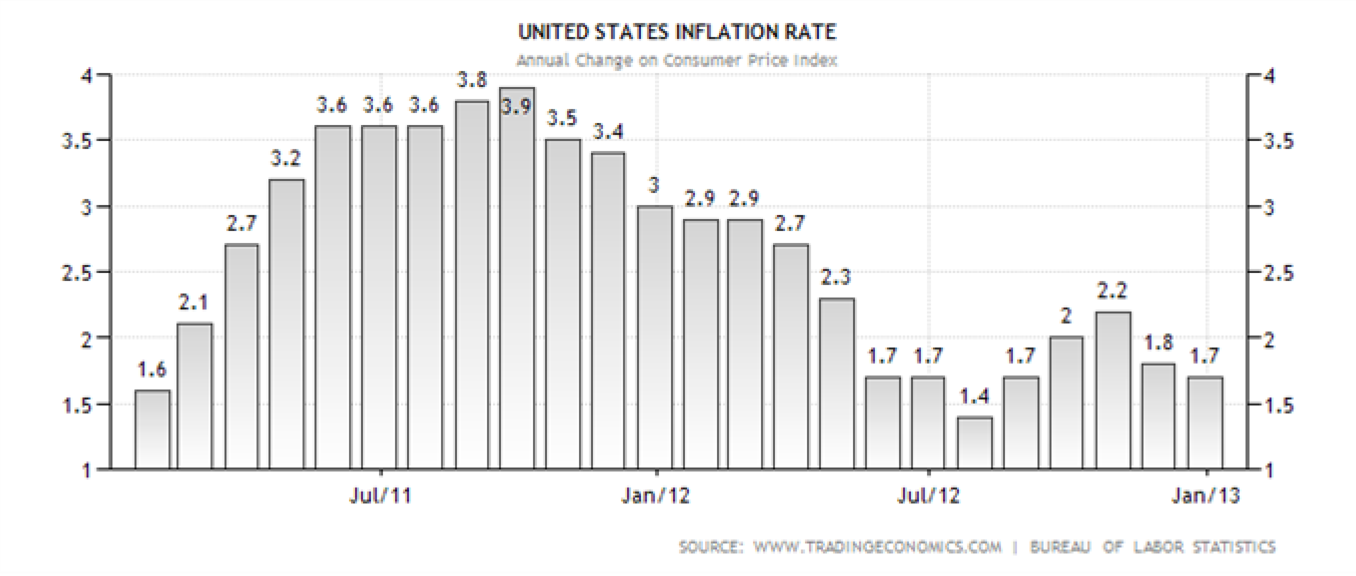
GDP is a major news release that Forex traders can use as a barometer to measure economic strength and weakness as well as interest rate expectations. Since Forex is traded in pairs, traders can pair a strong economy with high GDP with a weak economy with low GDP to find powerful trends. Traders are capitalizing on the flow from a weak currency to a strong currency as it oftentimes pays to be long the strong and short the weak.

Understanding the Consumer Price Index

Article Summary: *The USD is in a state of transition for 2013. With CPI being released on Thursday, traders will await the announcement to determine market direction.*

The Consumer Price Index, better known as the acronym CPI, is released on a monthly basis by most major economies to give a timely glimpse into current growth and inflation levels. Inflation tracked through CPI looks specifically at purchasing power and the rise of prices of goods and services in an economy which can be used to influence a nation’s monetary policy. The United States is set to release CPI data later this week,on Thursday February 21st at 13:30 GMT, as noted on the economic calendar.

Below you will see a chart displaying the historic results of CPI (YoY) for the United States. This month, expectations are set at 1.7 % growth compared relatively to last year's data. If CPI is released higher or lower than expectations this news event does have the ability to influence the market.One way we can interpret its affects is by monitoring the US Dollar Index.



Below you can see a chart of the US Dollar Index (DXY). If CPI is released away from expectations, it is reasonable to believe this may be the catalyst to drive the Index to fresh highs, or to rebound from resistance. Since the Index is comprised of the AUDUSD, USDJPY, EURUSD and GBPUSD this event by watching the USDollar we can get a full interpretation of the events outcome.

Learn Forex – DXY Index

Ultimately, once CPI data has been released, the trader will look to see if price has broken out or bounced back below standing resistance. If price breaks above resistance, it would be a strong signal to traders that the current bull trend on the USD is set to continue.

A move back lower would confirm a technical correction and indicate a fresh round of USD weakness. Regardless of the outcome, knowing this can help us better interpret market direction and place positions after this weekly event.

How to Use PPI in Forex Trading

Talking Points

- **PPI stands for the Producer Price Index.**
- **PPI comes out the second week of each month.**
- **Forex traders can use PPI as a leading indicator to forecast consumer inflation measured by the Consumer Price Index (CPI)**

In the 1950's gasoline was $0.27, apartment rent was $42/month and a movie ticket was $0.48. In addition,the US dollar was worth 9 times what is worth now. Inflation reduces domestic buying power and that is whycentral banks fight so hard to beat back inflation by raising the interest rate. Forex traders are well aware that interest rates are the main driver of currency movement. Investors seek higher yields and will migrate capital from low yielding assets and currencies to high yielding assets and currencies. This is why traders pay special attention to the Producer Price Index because it alerts them to the rise and fall of inflation which could, in turn, lead to a rise and fall of currency rates.

What is PPI?

Released monthly in the second week of each month, the Producer Price Index (PPI) is an indicator used to measure the average change in selling price, over time, received for finished goods.Retailers that have to pay more for finished goods may have to pass on higher costs to consumers. This measurement of price change from the view of the seller can be a leading indicator for consumer inflation that is measured by the Consumer Price Index (CPI). PPI examines three production areas; commodity-based, industrial-based, and stage-of-processing-based companies. Released by the Bureau of Labor Statistics, PPI is created using data collected from a mailed survey of retailers selected randomly. Traders can see changes in PPI expressed in a percentage change from the previous year or month to month.

Why Look at PPI?

Forex traders use the Producer Price Index to find the direction of prices and a measurement of inflation. Rising prices in the form of inflation lowers the purchasing power of a country's currency because consumers can buy less goods and services for each unit of currency. This decrease in consumer buying power usually triggers a central bank response to raise interest rates. A rising PPI could indicate that consumer prices could rise leading to higher interest rates. The increase in interest rates stimulates the demand for that currency as investors chase yield. This inflow of capital results in a higher exchange rate. On the other hand, a stable or falling PPI insures that interest rates will remain low. This results in a lower relative currency exchange rate. As you can see, using the information found in PPI can give traders an advantage when seeking out strong and weak currencies.

How Forex News Traders Use ISM Numbers

Talking Points

- The Institute for Supply Management (ISM) was founded in 1915 and is the first supply management institute in the world.
- Servicing 40,000 business professionals in more than 90 countries, ISM focuses on supply chain management.
- Forex traders rely heavily on ISM's release their Purchasing Managers Index (PMI) on the first business day of each month to gauge economic growth.

What is ISM?

A country's economy is as strong as its supply chain. The Institute for Supply Management (ISM) measures the economic activity from both the manufacturing side as well as the service side. Formed in 1915, ISM is the first management institute in the world with over 40,000 members in 90 countries. Since it can draw from information gathered from the surveying its large membership of purchasing managers, the ISM economic news releases are carefully watched by Forex traders around the world as a reliable guide to economic activity.

ISM Surveys

ISM publishes three surveys; manufacturing, construction, and services. Published on the first business day of the month, the ISM Purchasing Managers Index (PMI) is compiled from surveys of 400 manufacturing purchasing managers. These purchasing managers from different sectors represent five different fields; inventories and employment, speed of supplier deliveries, production level, and new orders from customers.

In addition, ISM construction PMI is released on the second business day of the month, followed by services on the third business day. Forex traders will look to these releases to determine the risks at any given time in the market.

Forex Market Impact

The Manufacturing and Non-manufacturing PMI's are big market movers. When these reports come out at 10:30 AM ET, currencies can become very volatile. Since these economic releases are based on the previous month's historical data gathered directly from industry professionals, Forex traders can determine if the US economy is expanding or contracting.

Forex traders will compare the previous month's number with the forecasted number that economists have published. If the released PMI number is better than the previous number and higher than the forecasted number, the US dollar tends to rally. This is where fundamental and technical analysis comes together to create a trade setup.

Learn Forex: EURUSD Drop on Better

(Created by Gregory McLeod)

In the example above, notice how the better than expected PMI number triggered a US dollar rally against the Euro. As seen in the chart above of the EURUSD, the ISM Non-Manufacturing was not only above 50 but at 55.4, beat the forecasts calling for a drop from 54.4 to 54.0.

When an economic release beats expectations, like in the example above, sharp fast moves can result. In this case, EURUSD dropped 22 pips in 15 minutes. Traders often choose the Euro as the "anti-dollar" to take advantage of capital flows between two of the largest economies.

The Euro zone has a large liquid capital markets which can absorb the huge waves of capital seeking refuge from the U.S. So a weak US ISM Non-Manufacturing number usually leads to a dollar sell-off and a rise in the Euro. Another scenario is when the number released is in line with forecasts and/or unchanged from the previous month, then the US dollar may not react at all to the number.

Overall, an ISM PMI number above 50 indicates that the economy is expanding and is healthy. However, a number below 50 indicates that the economy is weak and contracting. This number is so important that if the PMI is below 50 for two consecutive months, an economy is considered in recession.

PMI's are also compiled for Euro zone countries by the Markit Group while US regional and national PMIs are compiled by ISM. As you can see, traders have good reason to pay special attention to the important releases from the Institute of Supply Management.

Central Banking: A Study of Policy and Market Effects

Central Banking

Central Banks are institutions are utilized by nations around the world to assist in managing their commercial banking industry, interest rates and currency. The idea of a Central bank is not a new one though. The first examples of a central banking authority were seen in China with the first issuance of paper money nearly 1000 years ago. Other examples date back to the Knights Templar, looking for credit to finance their crusades. Many of the processes being tested in the past have been refined over hundreds of years of practice resulting in today's modern banking systems.

Examples of Central Banking today include the Federal Reserve of the United States, European Central Bank (ECB), Bank of England (BOE), Bank of Canada, and the Reserve Bank of Australia. There sphere of influence of a central bank may range from a single country such as the Reserve Bank of Australia or, represent policy created for a region or group of countries such as the ECB. To show the effects of Central Banking in a modern society, we will focus on the Federal Reserve of the United States and their policy decisions.

The Fed

The origins of Central Banking developed in the United States as far back as the Revolutionary War. In 1775 the Continental Congress met with the intention of developing a national currency and a plan to finance the developing war effort. The sole value of the "Continental" relied on the future tax collection of the future independent nation. As the revolution drew on with no conclusion, overprinting and counterfeiting brought about the devaluation and ultimate demise of the Continental currency. When the constitutional convention of 1787 convened, one of the first priorities was the discussion of the current financial system. As of 1791 the First Bank of the United States was issued its original charter.

Much has changed since 1787! The Central Banking system of the United States is now known as The Federal Reserve, or simply the "Fed". The modern Fed was created in 1913 by congress with the intent of providing the United States with a safer and consistently stable monetary system. The Federal Reserve achieves its goals by conducting monetary policy, and supervising and regulating banks.

Bank Regulations

The primary reason for the creation of the modern Federal Reserve System was to stave off banking panics in the United States. This issue came to a head in 1907 during what has been dubiously called the “Bankers Panic”. During this time, stocks on the New York Stock Exchange fell nearly 50% from their 1906 highs. The end result of this crisis is that many banks and business were forced to either close or declare bankruptcy. As people worried they funds were unsafe at local banks, they would rush to withdrawal funds creating a massive shortage of capital.

The Federal Reserve is setup to avert a crisis such as the one experienced in 1907. A system is set in place where short term needs of small local banks can be handled if a “run” on deposits occurs due to unexpected withdrawals or regional emergencies. The Federal Reserve can easily loan money to small regional banks at a nominal charge called the discount rate. Once a run has been met, banks can then return their obligation back to the Federal Reserve. This policy is one of many tools the fed utilizes assuring the solvency of financial markets and bank depositories.

What Exactly is Monetary Policy

Monetary policy is another tool directly at the Feds disposal to achieve its goals. Monetary policy describes the actions that the Fed takes to control the money supply inside of the United States. Depending on the state of the economy, the fed may select to either take an expansionary or contractionary policy, with the supply of money being influenced by two specific methods.

During times of economic slowdown, the Fed often selects to peruse an expansionary policy in the market. This process begins by expanding the monetary base and decreasing interest rates. The theory behind expansionary policy is to make money more available to banks and businesses in an attempt to increase growth and development. As a byproduct of an expansionary policy, fundamental indictors such as GDP are expected to grow and unemployment decline.

As the economy heats up, the Fed will consider taking on contractionary measures. At this point, the monetary base may begin to be restricted and interest rates can begin to increase. These actions make excess investment capital scares, and place a higher premium on lending. With less capital circulating, the economy is expected to contract and slow down. During a time of contraction, GDP is expected to decline and unemployment to contrarily increase.

Effects on Currency Rates

By controlling the money supply, and interest rates, the decisions mandated by the Federal Reserve System have a direct influence to the strength / weakness of the USD. Previously, we discussed that when an expansionary policy is put in place, the monetary base is increased and interest rates decrease. By supplying more money to the market and banks than what is demanded values increase. This over supply of funds creates a flood of cheap dollars onto the open market, effectively diluting their value. The same holds true with Interest rates in an expansionary environment. As interest rates move lower, it becomes easier to borrow funds and the value of a currency tends to decline.

The opposing scenario holds true when the Fed assumes a contractionary monetary policy. A decrease in money supplied on the open market make capital scare. Scarcity drives up value for remaining funds and increases the value of currency. Increasing interest rates also has the same affect. Higher rates make funds more expensive to borrow, the barrier for lending decreases the availability of funds. Again as capital becomes scarce, currency prices are expected to appreciate.

<u>What this Means to Traders</u>

Knowing which policy cycle a central bank is taking can be a fundamental asset to currency traders. One recent example of a bank taking expansionary measures is the European Central Bank. One policy the European Central bank has employed is the lowering of interest rates. From their peak levels of 4.25% in 2008, the rates have declined 3.25% to an effective rate of 1.00%. Factor this in with an expanding monetary base as new debt is extended and refinanced, the Euro has been in a state of decline versus most major currency pairs. Below we can see the Euros descent against the Australian Dollar from 2008 – present. So far this pair has produced a maximum trend of over 8000 pips. We can use this directional bias in the market to then proceed and trade the strategy of our choice.

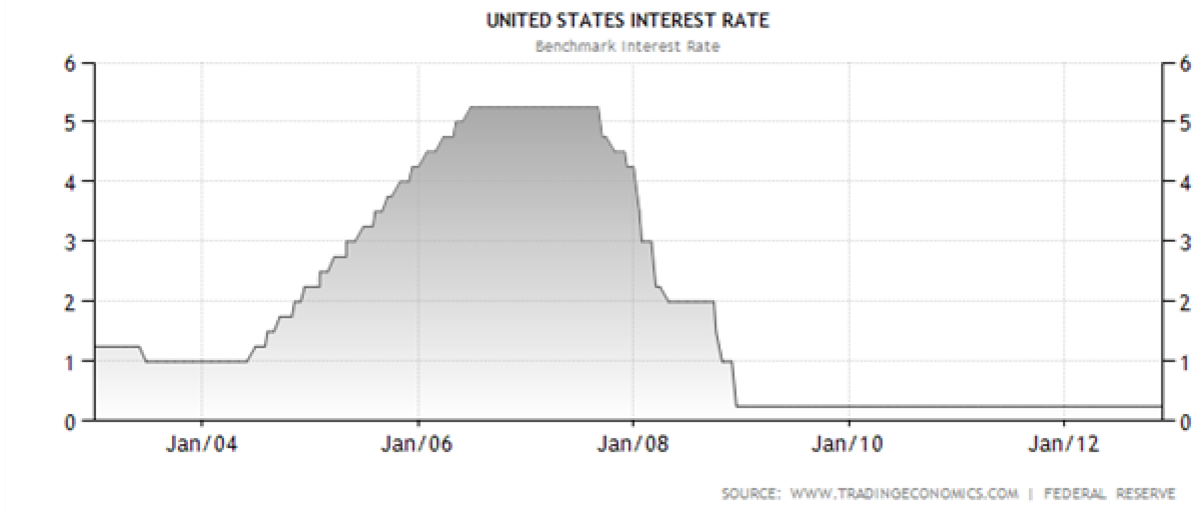
Learn Forex: Understanding the FOMC

Article Summary: *The FOMC (Federal Open Market Committee) rate decision is one of the most highly anticipated events on this week's economic calendar. Learn about the event and its possible effects.*

The FOMC (Federal Open Market Committee) rate decision is one of the most highly anticipated events on this week's economic calendar. The announcement is designed to inform everyone about the US Federal Reserve's decision regarding interest rates. A policy to increase, decrease or even keep key interest rates the same can have large effects on the currency market. To get an idea of what the FOMCs decision may be, let's review some of their past policy decisions.

Below we can see a graph depicting the changes in US Interest Rates since 2004. From 2004 through 2007 the Federal Reserve took a policy of raising interest rates. This is known as a tightening policy, which is normally used to control inflation. Since this point rates have decreased dramatically from a high of 5.25%.An expansionary policy has been in effect since 2008 as the Fed has used interest rates to expand the monetary base to spur the economy. The benchmark interest rate in the US currently stands at .25% where it is expected to remain for some time.

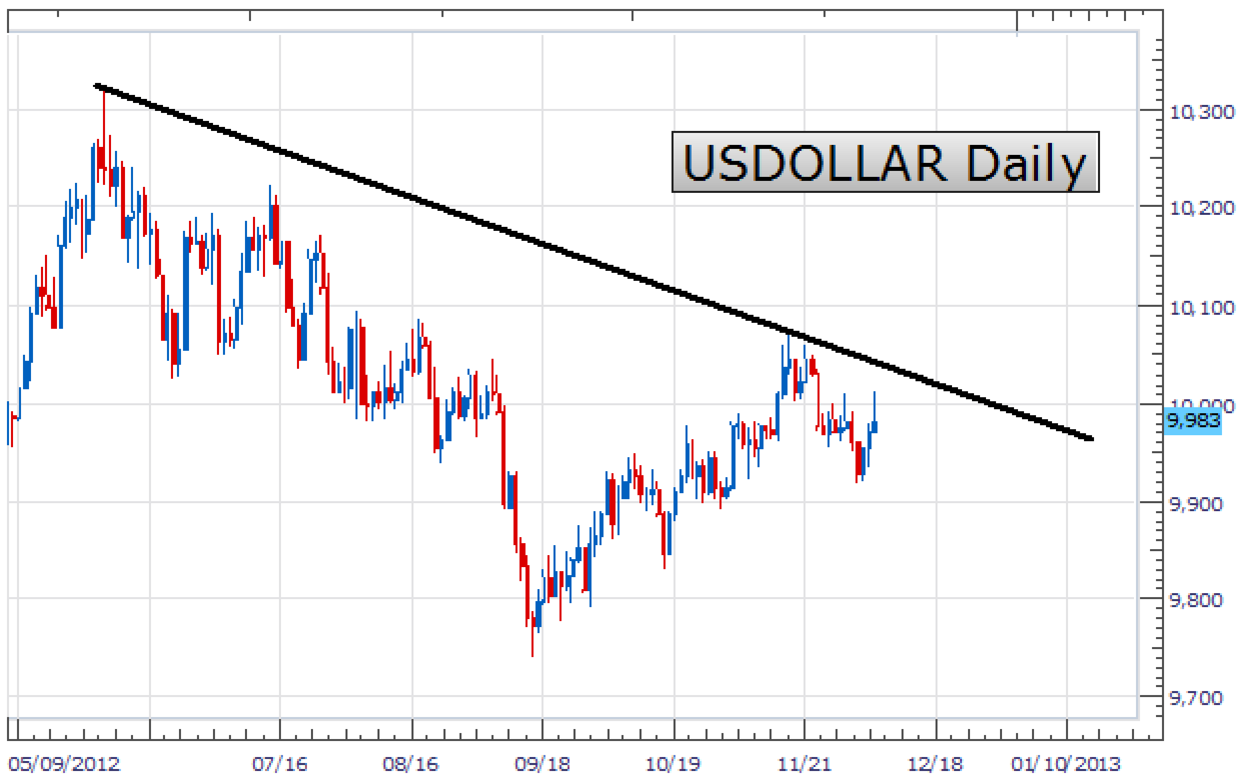
Learn Forex – US Benchmark Interest Rates



Ultimately by controlling interest rates, the Federal Reserve System has a direct influence to the strength / weakness of the USD. Previously, we discussed that when an expansionary policy is put in place, the monetary base is increased and interest rates decrease. By supplying more money to the market and banks than what is demanded values of goods increase. This over supply of funds creates a flood of cheap dollars onto the open market, effectively diluting their value. The same holds true with Interest rates in an expansionary environment. As interest rates move lower, it becomes easier to borrow funds and the value of a currency tends to decline.

This act of monetary easing by the Fed has had a direct effect on the US Dollar. Bellow you can see a Daily chart of the US Dollar Index (DXY). At present the FOMC is expected to hold key rates at .25%. If this is the case traders may reasonably expect continued devaluation of the US Dollar relative to other major currencies.

Learn Forex – Dollar Index



(Created by Walker England)

Once the FOMC releases their key interest rate decision it is also important to look for statements directly from the Fed. These statements can give traders hints at the Feds outlook on the future of the US economy as well as future rate decisions. Traders will often price in what they think will be the Fed’s next move making statements almost as important as the rate decision itself.