

TradeMentor

Chapter 1.3

Fundamentals Make Currency Pairs Move

FUNDAMENTALS MAKE CURRENCY PAIRS MOVE

The key to making money in the Forex is understanding what makes currency pairs move. Ultimately, it is investors who make currency pairs move as they buy and sell different currencies, but these investors buy and sell for a reason. Either they see something happening fundamentally in the global economy that makes them believe a currency is going to get stronger or they see something happening fundamentally that makes them believe a currency is going to get weaker. In other words, they watch the fundamentals and make their decisions according to what they see.

Fundamentals make currency pairs move. If the economic fundamentals in the United States are improving, the U.S. dollar (USD) will most likely be getting stronger because Forex investors will be buying dollars. Conversely, if the economic fundamentals in the United States are declining, the U.S. dollar (USD) will most likely be getting weaker because Forex investors will be selling dollars.

You can learn to watch the fundamental economic indicators that move currency pairs just like institutional investors do. In this section, we will explain the following to help you build a strong fundamental foundation:

Contents	Which fundamental economic indicators are most important
	Why interest rates are so important
	What impact inflation has on interest rates

NOT ALL ECONOMIC INDICATORS ARE IMPORTANT

Globalisation has brought us all closer together and has brought millions of pieces of information to our fingertips on a daily basis. Part of becoming a successful Forex investor entails learning how to ignore most of the news and information that bombards you every day so you can focus on the important information.

Not all economic indicators are important. You will see many fundamental economic announcements that you do not have to pay much attention to. For instance, unemployment in Ireland is not as important as unemployment in the United States. While Irish unemployment is certainly important in Ireland, the U.S. economy has a much larger impact on the global economy so investors watch U.S. economic announcements more closely.

Remember, it is ultimately large, institutional investors who move the Forex market so you want to watch the same things these investors are watching. Doing so enables you to more accurately predict what moves they will make so you can take advantage of those movements.

Example

One great way to take advantage of fundamentally driven price movement is to watch the news. You will learn how to profit from unexpected news when you complete the News Analysis section.

The most important fundamental economic indicators can be divided into the following three groups:

-	Interest rates
-	Economic strength
-	Capital and trade flow

You will learn more about economic strength and capital and trade flow indicators in later sections. In this section, you are going to learn about interest rates—the most important fundamental economic indicator in the Forex market.

INTEREST RATES: THE MOST IMPORTANT ECONOMIC INDICATOR

Interest rates rule the Forex market. Currencies representing economies with higher interest rates tend to be stronger than currencies representing economies with lower interest rates. Investors are always looking for the greatest return on possible on their investments, and economies with higher interest rates usually have higher yields on their investments.

Imagine you are walking down the street looking for a place to put your money and you see two banks, one on either side of the street. The bank on the right side of the street is offering to pay 6 percent interest on any money you deposit there. The bank on the left side of the street is only offering to pay 2 percent interest on any money you deposit there. Naturally, you would choose the bank offering to pay 6 percent interest because you want to make a better rate of return on your investment.

The same principle applies to economies and their respective currencies. If you can get a 6 percent return on your investments in the United Kingdom, but you can only get a 2 percent return on your investments

in Switzerland, you are most likely going to invest in the United Kingdom.

So how does this affect the value of the British pound (GBP)?

As more and more people put their money in investments in the United Kingdom, demand for British pounds (GBP) increases. Basic economics tells us that as demand increases, the value of the British pound (GBP) also increases.

Successful Forex investors always watch Central Banks (the organisations that set interest rates) closely to see if they are likely to raise interest rates, lower interest rates or leave interest rates unchanged in the future.

The most important central banks are as follows:

- United States—Federal Reserve (The Fed)
- European Union—European Central Bank (ECB)
- United Kingdom—Bank of England (BOE)
- Japan—Bank of Japan (BOJ)
- Switzerland—Swiss National Bank (SNB)
- Canada—Bank of Canada (BOC)
- Australia—Reserve Bank of Australia (RBA)
- New Zealand—Reserve Bank of New Zealand (RBNZ)

INFLATION IMPACTS INTEREST RATES

Successful Forex investors always watch central banks to see what they are going to do with interest rates. Successful Forex investors also watch the economic numbers that central banks watch when making their interest-rate decisions so they can more accurately determine what central banks might do.

One extremely important economic indicator central banks watch when making their interest-rate decisions is inflation. *Inflation* is a general rise in prices for goods and services. For example, you most certainly pay more for a litre of milk or a loaf of bread than you did 10 or 20 years ago. You've probably also heard people from earlier generations comment on how expensive everything is these days. We all deal with inflation.

Example

Inflation ran rampant in Germany after World War I. Brutal economic instability caused the dramatic devaluation of the German mark. You can get a sense of just how bad the situation was by looking at the price of German postage stamps. In April 1921, it cost approximately 0.60 German marks to mail a letter from one city to another. However, by December 1923—merely 15 months later—it cost approximately 100,000,000,000 marks to mail that same letter from one city to another. While this is certainly an extreme example, it drives the point home that inflation will always be a part of our lives.

Moderate inflation is generally accepted as a natural by-product of economic growth. Too much inflation, however, can hurt an economy.

Central banks are always on the lookout for rising inflation. When they see inflation rising to uncomfortable levels, they do whatever they can to curb that growth. One tool central banks use to curb inflation is interest rates—central banks can combat rising inflation by raising interest rates.

Higher interest rates make it more difficult for businesses and individuals to borrow money to buy and build new items, which slows economic growth and, as a result, inflation.

You, as a Forex investor, want to watch inflation rates to get a glimpse into what central banks may do with their interest rates. If inflation is rising, central banks will most likely raise interest rates, which is good for the representative currency of that economy. You should watch the following two economic inflation indicators to get an idea of what central banks are looking at:

Consumer Price Index (CPI): the economic indicator that measures how much a basket of goods that consumers regularly buy costs. The more money consumers have to spend on essential goods and services, the less money they have to spend on extra goods and services.

Producer's Price Index (PPI): the economic indicator that measures how much producers must pay for the raw materials they use to produce their finished goods. If prices for producers are rising, they will most likely pass those costs onto consumers.

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