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WHY INTEREST RATES MATTER TO FOREX TRADERS





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Introduction

Benchmark interest rates are something many professional Forex traders and Hedge Funds closely monitor.

But why is this the case? How do interest rates affect the currency markets and your Forex trading decisions? In this e-book we'll answer these questions.

Why do interest rates matter in Forex?

It's important that you understand why interest rates matter.

The reason is actually quite simple. High interest rates tend to increase the value of a currency; while low interest rates do the opposite.

It's why Forex traders pay a lot of attention to central banks that hint at changing their interest rate in the near future. These changes are essentially clues as to how the value of a currency will move.

So why do interest rates have this effect? Let's explore this in detail.

Firstly, a central bank's benchmark interest rate is effectively the cost charged to private banks for borrowing capital.

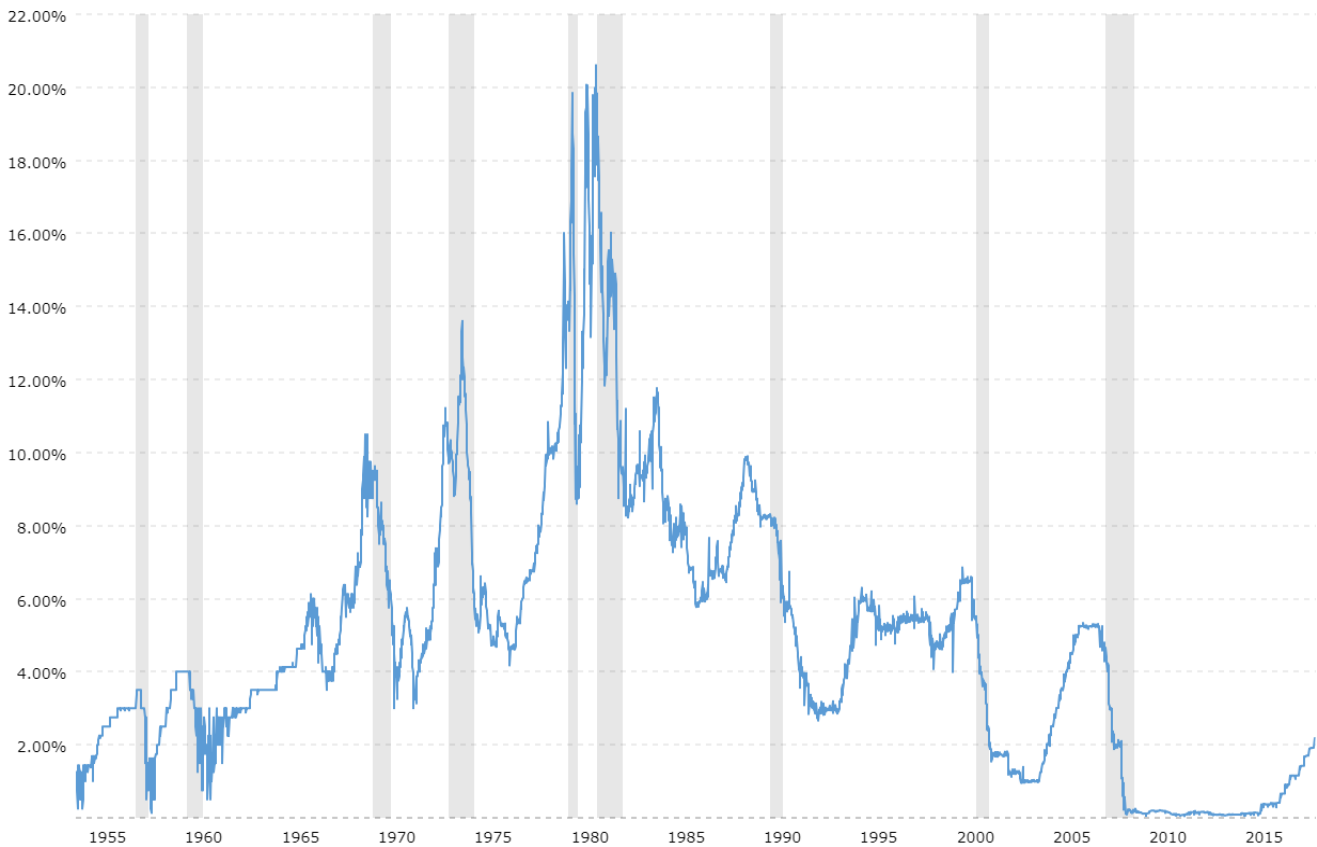
These interest rates are then usually passed on to consumers and businesses through various financial products from private banks. Examples of these products are bank accounts, mortgages and loans.

Higher interest rates mean that it is more expensive to borrow capital. They also encourage foreign investors, businesses and consumers to deposit money with private banks - as they receive an increased return for doing so. This increase in demand is why interest rates often act to strengthen the native currency.



Historically low interest rates since 2008

Since the global financial crisis of 2008, every major central bank has adopted historically low interest rates as part of its monetary policy (as demonstrated by this chart tracking U.S. interest rates since the mid 1950s).



*Source: Macrotrends (<https://www.macrotrends.net/2015/fed-funds-rate-historical-chart>)

Low interest rates were set in order to kickstart economies that had entered recession.

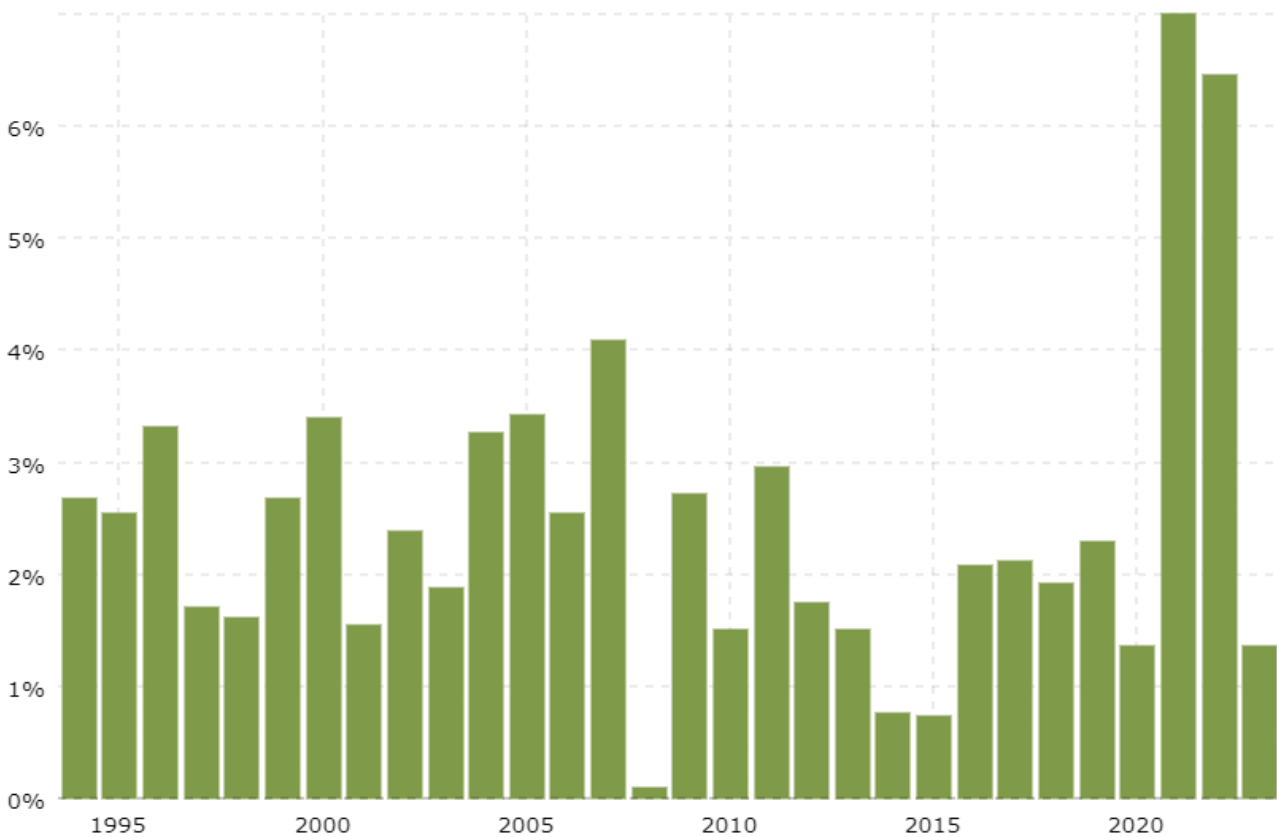
These economies typically had high unemployment rates and negative GDP growth. In an effort to remedy these problems, central banks enacted policies that encouraged an increase in the flow of capital within their economies.

This included setting low interest rates. By making it cheap for investors, businesses and consumers to borrow money - policymakers hoped economic growth would pick up.

To a degree, this has worked. But in recent years, other global events - such as Brexit and the Coronavirus pandemic - have made it difficult for major central banks to significantly increase interest rates.

Interest rates and inflation

Post-covid, inflation is the primary concern that most major economies face (as demonstrated by the chart below, which tracks U.S. inflation across the last 30 years).



*Source: Macrotrends (<https://www.macrotrends.net/2497/historical-inflation-rate-by-year>)

Interest rates typically rise with inflation because inflation erodes the purchasing power of money over time.

This means that as the general level of prices in the economy increases, the amount of goods and services that can be purchased with a fixed amount of money decreases.

To compensate for the loss in purchasing power caused by inflation, lenders require higher interest rates on loans. This is because they want to earn a return that is higher than the rate of inflation, in order to maintain the real value of their money.

In addition, when inflation is high, central banks often raise interest rates to try to slow down the economy and prevent prices from rising too quickly. This is because higher interest rates make borrowing more expensive, which can reduce consumer spending and investment, and ultimately slow down economic growth.

Overall, higher inflation leads to higher interest rates as lenders demand a higher return to compensate for the loss in purchasing power caused by inflation, and central banks use interest rates as a tool to control inflation.

When a country experiences high inflation, the value of its currency tends to decline in comparison to other currencies with lower inflation rates.

One way that inflation affects currencies is through changes in interest rates. When inflation rises, central banks may increase interest rates to try to control it. Higher interest rates can make a country's currency more attractive to investors seeking higher returns, which can lead to an increase in demand for the currency and a strengthening of its value.

Conversely, if inflation is higher in one country than in another, the purchasing power of the currency of the country with higher inflation will decline relative to the currency of the country with lower inflation. This can make imports more expensive and reduce the competitiveness of the country's exports, which can weaken the value of its currency.

Inflation can also affect currencies indirectly through its impact on the overall health of an economy. High inflation can be a sign of an overheating economy, which may lead to lower confidence among investors and a weaker currency. On the other hand, low and stable inflation can help to promote economic stability and lead to a stronger currency over time.

Conclusion

If you're interested in trading Forex, you should consider opening a Live or Demo Account with Finveo. You can easily trade CFDs (FX, Indices, Commodities and Cryptos) and Fractional Shares - and also benefit from 30+ years of expertise. [Just click here to start your journey.](#)

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