



Lesson 1

Fundamentals - What Moves the Currency Markets



Welcome to global financial markets! Just as a trader or investor can buy stock in a company, the foreign exchange (or *forex* for short) allows you to buy or sell *currencies*, which is in a way like owning a piece of the future rise or decline of an entire country's economy.

Supply and Demand

To determine where a particular country's economy may be headed next, traders turn to a variety of data, including: gross domestic product (GDP), imports, exports, employment, unemployment, growth, debt, and many other factors. Collectively, these are often referred to as the *fundamentals*.

Like any other market, the value of currencies responds to changes in *supply* and *demand*. When the world needs more Dollars, for example, the Dollar becomes worth more. When too many Dollars are available on the market, or the need for them declines for some reason, then the Dollar drops in value.

Currency Pairs

The world's currencies trade in *pairs* - one currency's value either rises or drops in comparison to another. Each currency has a 3-letter abbreviation, and the trailing currency of any pair is considered the *base* currency. The *price* at any given time tells you how much of the base currency is needed to equal exactly one unit of the leading currency.

For example, when the EUR/USD pair is priced at 1.5000, this means that it takes 1.5 US Dollars to exchange for 1 Euro. If the Euro rises in value, then the EUR/USD price will also rise, as more US Dollars are needed to buy each Euro. Likewise, if the Euro drops in value, then the price of the EUR/USD pair will also drop, as now you need less US Dollars to equal each Euro.



The value of the leading currency is not the only factor in the value of a particular pair. Any change in the value of the base currency obviously also affects this relationship. So, in the same example, if the US Dollar now rises in value, then the EUR/USD pair would drop, as now you need less Dollars to buy each Euro. And if the US Dollar drops in value, then the EUR/USD price would rise, as you need more of those US Dollars to equal each Euro.

Therefore, it can be said that each currency pair goes up and down in value proportionately to the rise or drop in value of its leading currency. Likewise, the same currency pair also moves up and down in an *inverse* relationship to the increases or drops in value of its base currency.








So if a trader expects that the US economy will go up, and the value of the US Dollar with it, then they may wish to sell the EUR/USD pair, since it will most likely go down in price in such a scenario. If the trader believes that the European economy will go up, bringing up the value of the Euro, then they would buy the EUR/USD pair instead.

Interest Rates

Another key factor which has an influence upon the value of a given currency is the interest rate that the central bank of a particular country charges for the use of its money. These interest rates are always changing, so it is wise to keep track of them.

For example, if the Federal Reserve in the United States (commonly referred to as the Fed) lowers its interest rate, then typically the value of the US Dollar will drop as well, causing the EUR/USD pair to rise. If the Fed raises rates, then the US Dollar will typically go up as well, causing the EUR/USD to drop.

The Fed's counterpart in the European Union is the European Central Bank (the ECB). If they raise their interest rate, then usually the value of the Euro will go up as well, causing the EUR/USD to rise. If they lower their interest rate, then typically the Euro will drop in value as well, causing the EUR/USD to fall.

 7.00%	 8.25%
 4.00%	 2.75%
 4.00%	 5.25%
 0.50%	 3.00%

Central banks are constantly caught in a delicate balancing act. If a country's currency rises too far, its exports become too expensive and other countries may look elsewhere. Interest rates are sometimes also cut in an attempt to stimulate the economy, but if they get too low then inflation can set in. Then it is time to start raising them again in order to slow growth.

Higher interest rates also tend to attract more foreign investments (which is why the currency of that country frequently goes up in step with the interest rates), meanwhile cheaper interest rates tend to stimulate lending inside the country and therefore economic growth.