Fundamentals on Forex

Article

There are many games to try your luck but definitely forex trading is not a game of chance. We therefore always advise our clients to at least gain a basic understanding of the Forex market and what influences the prices of different currency pairs before they start trading. In general, fluctuations in exchange rates are caused by Fundamental and/or Technical factors. In this article we outline the basic fundamental considerations.

1. Political conditions
2. Actual monetary flows (flows for imports, exports, mergers, acquisitions) and expectations of changes in monetary flows.
3. Major news which is released publicly, often on scheduled dates and times which include:

    a. Economic policy formulated by central banks,
    b. Economic conditions generally revealed through economic reports (GDP growth, inflation, unemployment, relative interest rates, budget and trade deficits or surpluses, consumer confidence etc.).

Political Conditions

Internal, regional, and international political conditions and events can have a profound effect on currency markets. All exchange rates are susceptible to political instability (ahead of elections for example) and anticipations about the new ruling party. Political upheaval and instability can have a negative impact on a nation's economy. Also, events in one country or a region may spur positive or negative interest in a neighbouring country and, in the process, affect its currency.

Monetary Flows

Large mergers and acquisitions can create an often temporary demand for a particular currency which can cause the currency to strengthen. The trade flow between countries illustrates the demand for goods and services, which in turn indicates demand for a country's currency to conduct trade. Surpluses and deficits in trade of goods and services reflect the competitiveness of a nation's economy. Large trade deficits (imports > exports) usually have a negative impact on a nation's currency.

Economic Policy

1. Fiscal policy which is essentially the way a government chooses to manage its revenues (tax) and expenses (spending on health, education and defence). The difference between the two is the government deficit/surplus. A country’s currency usually reacts negatively to widening government budget deficits, and positively to narrowing budget deficits.

2. Monetary is the policy which is the way in which a government's central bank influences the supply and "cost" of money. The cost of money is reflected on a currency’s interest rate while the money supply is managed with the buying or selling by the central banks of government bonds. High real interest rates (nominal interest rates less inflation) usually tend to attract capital causing a currency to strengthen. The level of interest rates also affects the domestic economy in that a high interest rate tends to slow economic growth and inflation, while in periods of low growth or deflation central banks use low interest rates to stimulate growth or bring inflation back to target. Adding money supply (buying government bonds back from the market-quantitative easing) is used to stimulate growth and inflation, whereas withdrawing money supply (selling government

bonds) is slowing growth and inflation. Excess money supply tends to weaken a country's currency while low money supply tends to strengthen a country's currency.

Economic conditions

There are many economic statistics published on a weekly/monthly basis (you can keep track of upcoming data and expectations by checking our Economic calendar on www.tfifx.com- In the calendar we provide a short description of the data, the previous release number as well as the market expectation for the upcoming release). Traders watch these figures closely, forecasting the likely result and reacting to the actual figure according to whether it is better than forecast, in which case the market will rise, or worse than forecast, in which case the market will fall. The most closely watched data are:

1. **Inflation levels and trends**
   Typically a currency will lose value if there is a high level of inflation in the country or if inflation levels are perceived to be rising. This is because inflation erodes purchasing power, thus demand, for that particular currency. However, a currency may sometimes strengthen when inflation rises because of expectations that the central bank will raise short-term interest rates to combat rising inflation.

2. **Economic growth and health**
   Reports such as GDP, employment levels, retail sales, capacity utilization and others, detail the levels of a country's economic growth and health. Generally, the more healthy and robust a country's economy, the better its currency will perform. While economic numbers reflect economic policy, some reports and numbers can have a more muted or dubious effect: the number itself becomes important to market psychology and may have an immediate impact on short-term market moves, however, what influences the market on a sustained basis can change over time. In recent years, for example, money supply, employment, trade balance figures and inflation numbers have all taken turns in the spotlight.

3. **Market psychology**
   Unsettling international events can lead to a "flight to quality," with investors seeking a "safe haven". Under such market conditions, there will be a greater demand and thus a higher price for currencies perceived as safer over their relatively riskier counterparts. The Swiss franc and US dollar have been traditionally perceived to be safe havens and usually gain during times of political or economic uncertainty.

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