Market Talks
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FOREX · BEGINNER · LESSON 7 OF 15

What Moves Currencies

The forces behind every exchange rate, from interest rates and inflation to risk mood and political shocks, and why surprises matter more than the news itself

12 min read 8 quiz questions with answer key

FOREX · BEGINNER · LESSON 7 OF 15

What Moves Currencies

IN ONE SENTENCE

Exchange rates move when demand for one currency changes against another. The biggest long-term drivers are interest rates, inflation, economic growth and trade. In the short term, prices react to how data and events compare with what the market expected, to the general mood of investors and to sudden political shocks.

It all comes down to supply and demand

A currency is priced like anything else in a market. If more people want to buy euros with dollars than want to sell them, the price of the euro in dollars, EUR/USD, goes up. If more want to sell, it goes down.

So the real question is: **what makes people want to hold one currency rather than another?** The answer is a mix of reasons. Investors want the best return on their money. Companies need currencies to pay for goods. Some people want safety in uncertain times. And traders try to buy before everyone else does.

This lesson walks through the most important of these forces. None of them works alone, and their influence changes over time, but together they explain most of what you see on a currency chart.

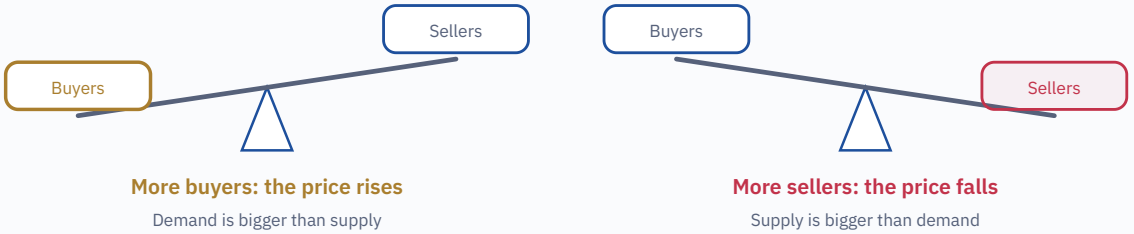


Figure 1. A currency's price moves with supply and demand. When buyers outweigh sellers the price rises; when sellers outweigh buyers it falls.

The six main drivers

Most currency moves can be traced back to six groups of causes:

- **Interest rates**, the most important single driver for the major currencies.

- **Inflation**, which affects both the value of money and what central banks do next.
- **Growth and jobs**, which show how strong an economy is.
- **Trade and commodities**, the money that flows in and out of a country to pay for goods.
- **Risk mood**, whether investors feel confident or fearful.
- **Politics and surprises**, from elections to sudden crises.

The following sections look at each of them. Notice how often they lead back to the first one: interest rates, and the central banks that set them. That is why the next lesson, Lesson 8, is about central banks.

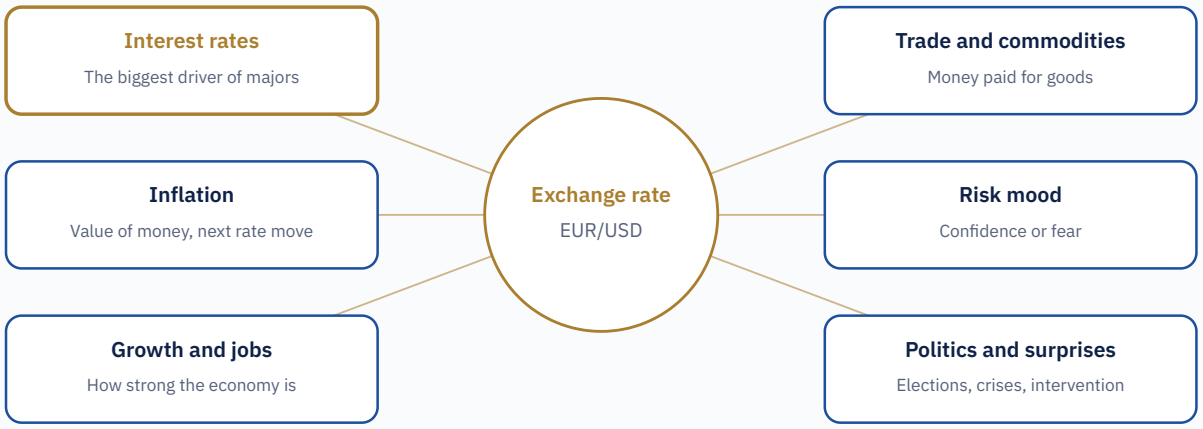


Figure 2. Six groups of causes explain most currency moves. Interest rates are the most important for the major pairs.

Interest rates: money looks for the best return

Large investors, such as pension funds, insurers and banks, move huge amounts of money around the world in search of a good, safe return. If interest rates are 5% in one country and 1% in another, money held in the first country earns more. To put money there, investors first need to buy that country's currency.

So, all else being equal, **a currency tends to strengthen when its interest rates rise, or are expected to rise, compared with other countries**, and to weaken when they fall. What matters most is not the level of rates on its own, but the **difference** between two countries' rates, often called the rate differential, and where markets think it is heading.

This is why traders watch central banks so closely, and why a single comment from a central bank governor can move a currency more than a whole week of economic data.

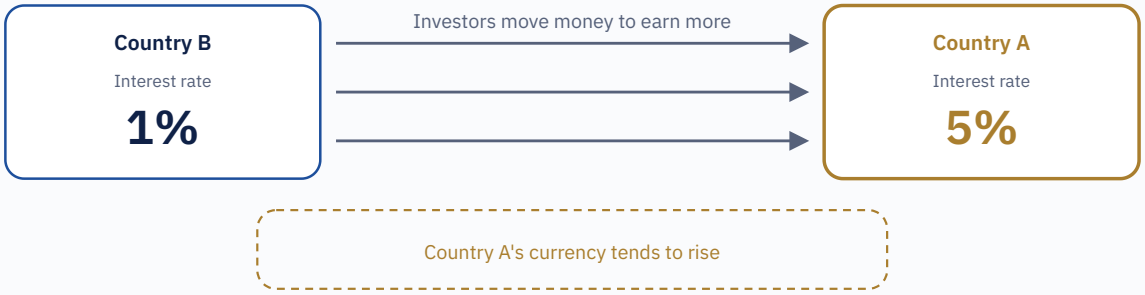


Figure 3. Investors move money towards higher interest rates, and they need the local currency to do it. The rates shown are examples.

Inflation, growth and jobs

Inflation is the rise in prices over time. Over many years, a currency with high inflation tends to lose value against currencies with low inflation, because each unit buys less and less. But in the short term, the effect often looks the other way round: when inflation comes in higher than expected, traders expect the central bank to raise interest rates to fight it, and the currency can **rise**. This is a common surprise for beginners.

Growth and jobs work more simply. A growing economy with rising employment attracts investment, supports higher interest rates and usually supports the currency. A weakening economy does the opposite. The figures traders watch most include:

- **GDP** (gross domestic product), the total output of the economy.
- **Employment reports**, such as the US monthly jobs report, often called non-farm payrolls (NFP).
- **Inflation figures**, such as the consumer price index (CPI).
- **Business surveys**, such as purchasing managers' indexes (PMI), which give an early view of activity.

Lesson 9 shows when these figures are released and how to follow them on an economic calendar.

What matters is the surprise

Here is one of the most important ideas in this lesson. Before every major data release, economists publish a **forecast**, and markets trade on it in advance. By the time the number comes out, the expected result is usually already in the price. Traders say it is **priced in**.

So the market does not react to whether a number is good or bad. It reacts to whether it is **better or worse than expected**. If economists expect 180,000 new US jobs and the report shows 250,000, the dollar may jump. If it shows exactly 180,000, there may be little reaction, even though 180,000 new jobs is good news. If it shows 100,000, the dollar may fall.

This also explains a saying you will hear: "buy the rumor, sell the fact". A currency can rise for weeks while traders expect good news, and then fall on the day the news is confirmed, because there is no one left to buy.



Figure 4. The market reacts to how a number compares with the forecast, not to whether it is good or bad. The numbers are examples.

Trade, commodities and risk mood

Every time a country sells goods abroad, its exporters receive foreign currency and eventually exchange much of it into their own. A country that exports much more than it imports therefore has a steady source of demand for its currency. For commodity exporters this link is especially visible: the Canadian dollar often moves with oil prices, and the Australian dollar with metals and with demand from China (Lesson 2).

Then there is the general **risk mood** of investors:

- In a **risk-on** mood, investors feel confident. Stock markets rise, and money flows into higher-yielding and commodity-linked currencies such as the Australian, New Zealand and Canadian dollars.
- In a **risk-off** mood, investors are fearful. Stocks fall, and money moves into safe havens: the US dollar, the Japanese yen, the Swiss franc and gold.

Risk mood can change in hours, for example after a bank failure, a war or a sharp fall in stocks, and it can overwhelm every other driver for a while.

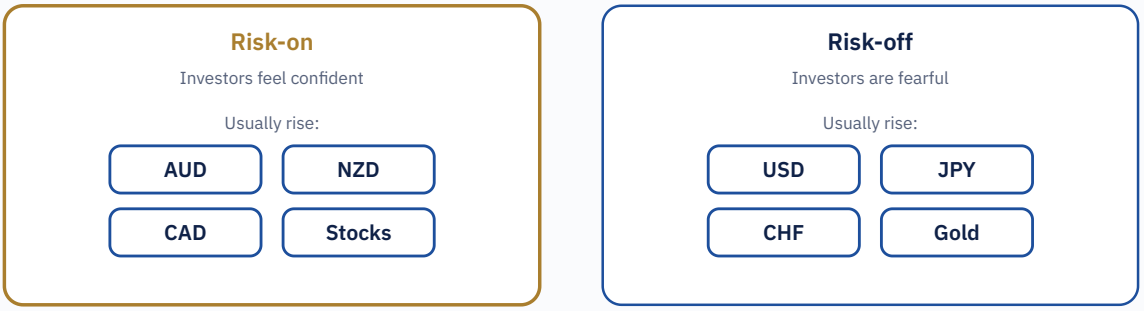


Figure 5. Risk mood. Confidence lifts commodity currencies and stocks; fear lifts the safe havens.

Politics and shocks

Elections, referendums, government budgets, trade disputes and conflicts can all change how investors see a country. The biggest moves happen when the result is a **surprise**, for the same reason as with economic data.

Governments and central banks can also step into the market directly, buying or selling their own currency to slow down a move. This is called **intervention**. In September and October 2022, for example, Japan spent about 9.2 trillion yen buying yen after it fell to its weakest level against the dollar in more than 30 years. Lesson 8 explains intervention in more detail.

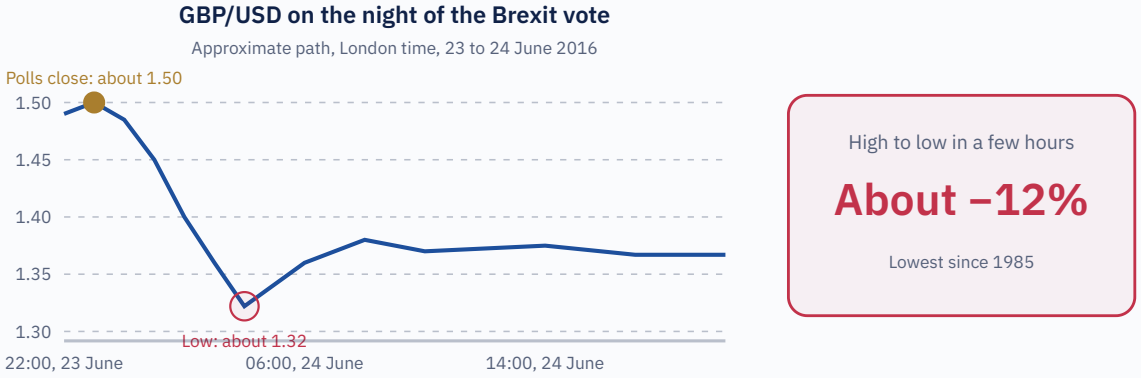


Figure 6. A political surprise. GBP/USD fell about 12% from its high to its low in a few hours after the Brexit vote. The path is approximate.

EXAMPLE: THE NIGHT OF THE BREXIT VOTE

On 23 June 2016 the UK voted on whether to leave the European Union. Most traders expected a vote to remain, and GBP/USD traded near 1.50 as the polls closed. As results came in overnight showing a vote to leave, the pound collapsed to about 1.32, its lowest level since 1985, a fall of roughly 12% in a few hours. By the end of the next day it was still down about 8%, one of the biggest one-day falls in the pound's history. Traders with large positions and no stop loss suffered enormous losses.

Different drivers for different time frames

Not every driver matters on every time frame. A useful way to organize them is by how long their influence usually lasts:

- **Minutes to hours:** data surprises, central bank comments, breaking news and large orders, such as at the London fix (Lesson 6).
- **Weeks to months:** expectations for interest rates, central bank meetings and changes in risk mood.
- **Years:** differences in growth, inflation, productivity and trade between countries.

A short-term trader cares most about the first group but should always know the bigger picture, because the longer-term trend often decides which way the short-term moves tend to break. A longer-term trader focuses on the second and third groups and treats the daily noise as just that.



Figure 7. Different drivers work on different time frames.

Why this matters for traders

- **Know the forecast before the number.** Check the expected result of every major release you trade around. The reaction depends on the surprise, not on the headline.
- **Follow interest-rate expectations.** Changes in what markets expect from central banks drive the biggest and longest moves in the major pairs.
- **Watch the risk mood.** On fearful days, safe havens such as the yen, the Swiss franc, the dollar and gold often rise together, while commodity currencies fall.
- **Respect scheduled political events.** Before elections and referendums, consider smaller positions or no positions at all. A surprise result can move prices further than any stop loss can protect you from.

Key terms

Rate differential	The difference between the interest rates of two countries, a key driver of their exchange rate.
Inflation	The general rise in prices over time, which reduces what each unit of money can buy.
GDP	Gross domestic product, the total value of goods and services an economy produces.
Non-farm payrolls (NFP)	The monthly change in US jobs outside farming, one of the most watched economic releases.
CPI	The consumer price index, the most common measure of inflation.
Priced in	Already reflected in the market price, because traders expected it in advance.
Risk-on	A market mood in which investors feel confident and buy riskier assets.
Risk-off	A market mood in which investors are fearful and move money into safe havens.
Safe haven	An asset that investors buy in times of fear, such as the yen, the Swiss franc, the US dollar or gold.
Intervention	When a government or central bank buys or sells its own currency in the market to influence its value.

Key takeaways

1. Exchange rates move with supply and demand for each currency, which depend on returns, trade, safety and expectations.
2. Interest rates, and especially the difference between two countries' rates, are the most important driver of the major pairs.
3. Markets react to surprises: what matters is how data compares with the forecast, because the expected result is already priced in.
4. In a risk-on mood commodity currencies tend to rise; in a risk-off mood the dollar, yen, Swiss franc and gold tend to rise.
5. Political shocks and intervention can cause sudden, very large moves, and different drivers matter on different time frames.

Test yourself

Circle one answer for each question. The answer key with explanations is on the next page. You can also take this quiz online at markettalks.info and see your score instantly.

1. More traders want to buy euros with dollars than want to sell them. What happens to EUR/USD?

- A It falls
- B It rises
- C It stays the same
- D It stops trading

2. Country A raises interest rates while Country B keeps them low. What usually happens to Country A's currency?

- A It tends to weaken
- B It tends to strengthen
- C Interest rates have no effect on currencies
- D It is fixed by law

3. US inflation comes in higher than expected. What is a common short-term reaction?

A. The dollar falls because prices are rising
B. The dollar rises because traders expect higher interest rates
C. Nothing, because inflation only matters over years
D. All currencies fall equally

4. Economists expect 180,000 new US jobs, and the report shows exactly 180,000. What is the most likely reaction?

A. A big rise in the dollar
B. A big fall in the dollar
C. Little reaction, because the result was already priced in
D. The market closes for the day

5. What does "buy the rumor, sell the fact" describe?

A. Buying only on Fridays
B. A currency rising while good news is expected, then falling when it is confirmed
C. Selling a currency before any news
D. Ignoring news completely

6. In a risk-off mood, which currencies usually rise?

A. The Australian and New Zealand dollars
B. The US dollar, Japanese yen and Swiss franc
C. Currencies of oil exporters only
D. Emerging market currencies

7. Oil prices rise sharply. Which currency is most often helped?

A. The Japanese yen
B. The Canadian dollar
C. The Swiss franc
D. The euro

8. After the Brexit vote in June 2016, how far did GBP/USD fall from its high to its low within a few hours?

A About 1%

B About 3%

C About 12%

D About 40%

Answer key

1 B

It rises

When demand for the euro is higher than supply, its price in dollars rises, so EUR/USD goes up.

2 B

It tends to strengthen

Higher rates attract investors looking for a better return. They need Country A's currency to invest there, which tends to push it up.

3 B

The dollar rises because traders expect higher interest rates

In the short term, higher inflation often makes traders expect the central bank to raise rates, which can lift the currency.

4 C

Little reaction, because the result was already priced in

The expected result is usually already in the price before the release. Markets move most on surprises.

5 B

A currency rising while good news is expected, then falling when it is confirmed

Traders buy while they expect good news. Once it is confirmed, there are few buyers left, and some take profits, so the price can fall.

6 B

The US dollar, Japanese yen and Swiss franc

When investors are fearful, they move money into safe havens such as the dollar, the yen, the Swiss franc and gold.

7 B

The Canadian dollar

Canada is a large oil exporter, so higher oil prices bring more foreign money into the country and often support the Canadian dollar.

8 C

About 12%

The pound fell from near 1.50 to about 1.32, roughly 12%, because the result surprised a market that had expected a vote to remain.

SOURCES

- CNN Money, British pound crashes to 31-year low after Brexit vote (24 June 2016): https://money.cnn.com/2016/06/24/investing/pound-crash-eu-referendum/
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