Market Talks
EDUCATION CENTER

FOREX · BEGINNER · LESSON 8 OF 15

Central Banks and Interest Rates

Who the central banks are, how a rate decision travels through the economy into the currency, and how traders read hawks, doves and expectations

12 min read 8 quiz questions with answer key

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Central Banks and Interest Rates

IN ONE SENTENCE

Central banks set the interest rates that drive the biggest moves in the major currency pairs. They raise rates to fight inflation and cut them to support a weak economy. Markets try to predict every decision in advance, so currencies react most to surprises and to hints about what the bank will do next.

What a central bank does

Every currency has a central bank behind it. The central bank issues the currency, supervises the banking system and, most importantly for traders, sets the country's **main interest rate**, often called the **policy rate**.

Most central banks have one main goal: **stable prices**, usually defined as inflation of about 2% a year. Some have more than one goal. The US Federal Reserve, for example, has a dual mandate: stable prices and maximum employment.

To reach its goal, a central bank adjusts its policy rate at regular meetings. These are the eight central banks behind the major currencies:

Central bank	Currency	Inflation goal	Rate decisions per year
Federal Reserve (Fed)	USD	2%	8
European Central Bank (ECB)	EUR	2%	8
Bank of Japan (BoJ)	JPY	2%	8
Bank of England (BoE)	GBP	2%	8
Swiss National Bank (SNB)	CHF	Below 2%	4
Bank of Canada (BoC)	CAD	2%, within 1% to 3%	8
Reserve Bank of Australia (RBA)	AUD	2% to 3%	8
Reserve Bank of New Zealand (RBNZ)	NZD	2%, within 1% to 3%	7

Meeting dates are published well in advance on each bank's website and on every economic calendar (Lesson 9).

How a rate decision reaches the currency

When a central bank changes its policy rate, the effect spreads step by step:

1. The **policy rate** changes the cost of money for banks.
2. Banks pass it on: **loan and savings rates** for households and companies rise or fall.
3. **Bond yields**, the return on government and company bonds, adjust as well, especially for shorter maturities.
4. Higher returns attract foreign investors, who need the local currency to invest. Lower returns push money out. So the **currency** tends to rise when rates go up and fall when they come down.

At the same time, the decision works on the economy itself. Higher rates make borrowing more expensive, slow down spending and, over months, bring inflation down. Lower rates do the opposite. Because these effects take time, central banks try to act **before** problems become large, which is why they talk so much about the future.

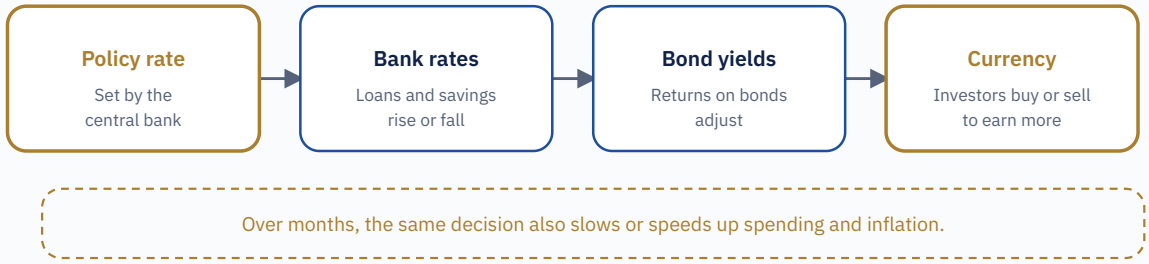


Figure 1. How a change in the policy rate travels to the currency, through bank rates and bond yields.

Hawks and doves

Traders describe a central bank's attitude with two birds:

- A **hawkish** central bank is worried about inflation. It is raising rates, or keeping them high, and suggests it may do more. Hawkish news tends to **strengthen** the currency.
- A **dovish** central bank is worried about growth and jobs. It is cutting rates, or keeping them low, and suggests more support may come. Dovish news tends to **weaken** the currency.

The same words describe individual policymakers. Each central bank has a committee that votes on rates, and traders follow the speeches of its members closely. A sentence such as "we are prepared to raise rates further if needed" is hawkish; "we will be patient" usually sounds dovish.

What matters for a currency is often the **change** in tone. A central bank that moves from hawkish to slightly less hawkish can weaken its currency, even though rates are still high.

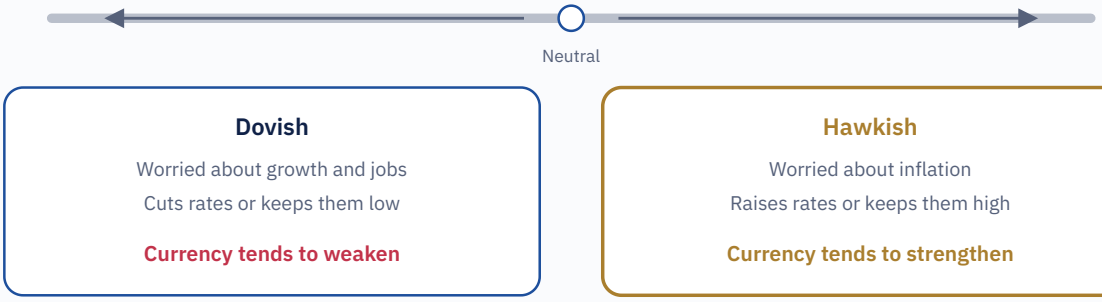


Figure 2. Hawkish and dovish. What moves a currency is often the change in tone, not only the level of rates.

Expectations: the decision is often already in the price

As you saw in Lesson 7, markets react to surprises. This is especially true for central banks. Before each meeting, the expected decision is visible in the prices of interest-rate futures and short-term bonds, and financial news sites publish the market's probability of a hike, a cut or no change.

Suppose the market is almost certain of a 0.25% hike:

- A **0.50% hike** is a hawkish surprise, and the currency usually jumps.
- A **0.25% hike** is what everyone expected, so the reaction depends on the details: the statement, the vote and the hints about the next meetings.
- **No change** is a dovish surprise, and the currency usually falls, even though rates did not go down.

This is why traders read every word of the statement and listen to the press conference after the decision. Often the biggest move comes not from the rate itself, but from what the central bank says about the future, a practice called **forward guidance**.

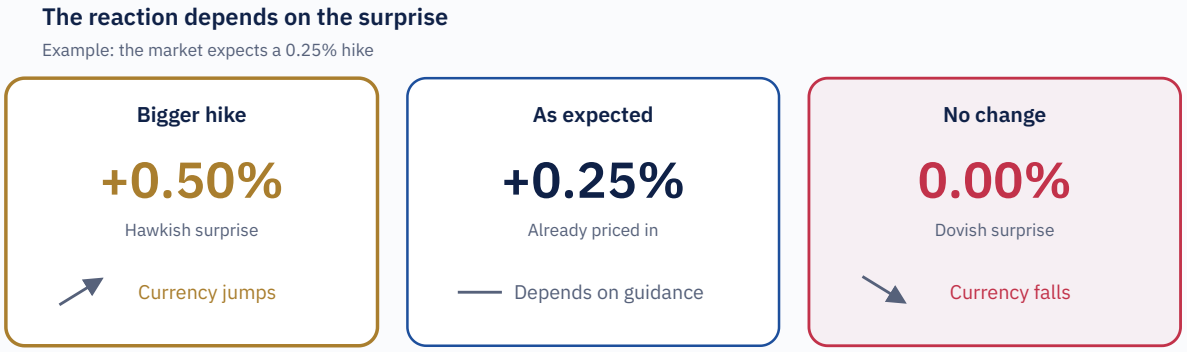


Figure 3. Before a decision, the expected result is usually already in the price. Currencies react to the surprise and to the guidance.

When two central banks go different ways

A currency pair is the meeting point of two central banks. The strongest trends often appear when they move in **opposite directions**, so the interest-rate gap between the two currencies grows quickly.

2022 gave a clear example. To fight the highest US inflation in about 40 years, the Fed raised its rate from almost zero in March to a range of 4.25% to 4.50% by December. The Bank of Japan kept its short-term rate at −0.1%. The gap between dollar and yen interest rates grew month by month, and USD/JPY rose from about 115 at the start of the year to almost 152 in October, the weakest level for the yen since 1990.

The trend only paused when Japan intervened in the market, and when US inflation began to slow. Lesson 7 showed why rate differentials pull money towards the higher-yielding currency; this chart shows how powerful that pull can be.

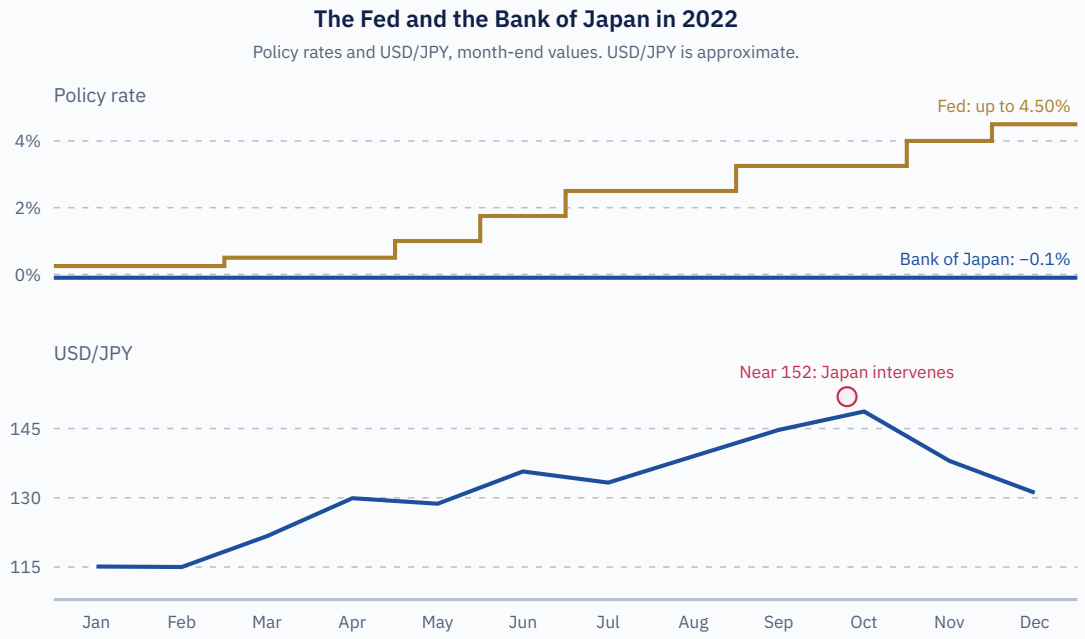


Figure 4. In 2022 the Fed raised rates sharply while the Bank of Japan kept its rate below zero. The widening gap pushed USD/JPY to almost 152 before Japan intervened.

More tools than just the rate

Interest rates are the main tool, but central banks have others:

- **Quantitative easing (QE)**: buying large amounts of government bonds to push long-term interest rates down. The reverse, letting those bonds run off or selling them, is **quantitative tightening (QT)**. QE tends to weaken a currency; QT tends to support it.
- **Forward guidance**: telling markets what the bank expects to do in the future. The Fed, for example, publishes its members' rate projections four times a year in a chart traders call the **dot plot**.
- **Currency intervention**: buying or selling the currency directly. In September and October 2022, Japan spent about 9.2 trillion yen buying yen, its first intervention to support the yen since 1998. The Swiss National Bank has also intervened many times, usually to stop the franc from getting too strong.

Interventions can move a pair by several percent in minutes, but they rarely change a trend on their own unless interest rates change too.

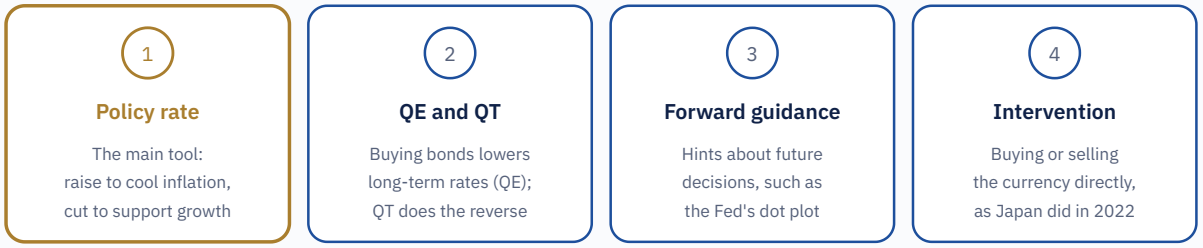


Figure 5. The four main tools central banks use to influence interest rates and their currency.

What happens on decision day

Every central bank follows a regular routine, and knowing it helps you avoid being surprised. Taking the Fed as an example:

- About ten days before each meeting, Fed officials stop giving speeches about policy. This is called the **blackout period**.
- On decision day, the rate decision and a short **statement** are released at **2:00 p.m. New York time** (19:00 UTC in winter). At four meetings a year, new economic projections and the dot plot come out at the same time.
- At **2:30 p.m.**, the Fed chair holds a **press conference**. Prices often move a second time, sometimes in the opposite direction, as the chair answers questions.
- About **three weeks later**, the **minutes** of the meeting are published, with more detail on the discussion.

Other central banks follow similar patterns at different times of day. Spreads widen and prices can jump in both directions around these moments (Lesson 3). If you are a beginner, it is usually wise not to hold a large position into a central bank decision.

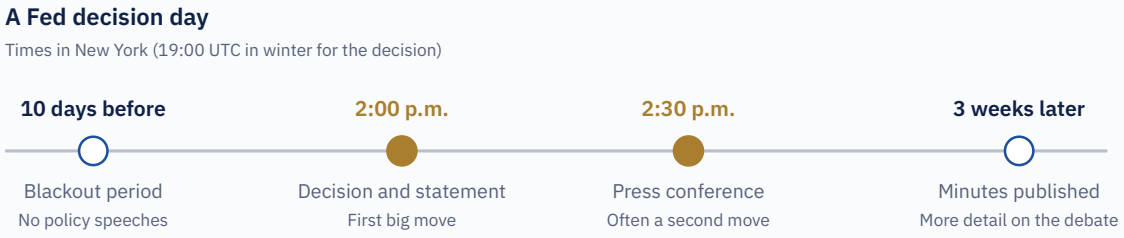


Figure 6. The routine around a Fed decision. Other central banks follow similar patterns at different times of day.

EXAMPLE: DAVID WATCHES A FED DECISION

The market expects the Fed to keep rates unchanged, and it does. EUR/USD barely moves at 2:00 p.m. But in the press conference, the chair says inflation is "still too high" and that a hike at the next meeting is "on the table". Traders start to expect higher US rates, the dollar strengthens, and EUR/USD falls 60 pips in half an hour. David, who was watching from the sidelines, notes in his journal that the real move came from the guidance, not from the decision.

Why this matters for traders

- **Know both central banks behind your pair.** Every pair is two central banks. The strongest trends come when they move in different directions.
- **Track expectations, not just decisions.** Check what the market expects before each meeting. The reaction depends on the surprise and on the guidance.
- **Mark the meeting dates.** Put every decision for the currencies you trade in your calendar, and treat those hours with care: spreads widen and prices can jump both ways.
- **Gold listens to central banks too.** Higher interest rates make non-yielding gold less attractive, so hawkish Fed news often weighs on XAU/USD, while dovish news supports it. Lesson 13 explains this link.

Key terms

Central bank	The institution that issues a currency and sets the country's main interest rate, such as the Fed or the ECB.
Policy rate	The main interest rate set by a central bank, which influences all other rates in the economy.
Mandate	The goal or goals a central bank is required to pursue, such as stable prices.
Hawkish	Focused on fighting inflation, favoring higher interest rates. Usually supports the currency.
Dovish	Focused on supporting growth and jobs, favoring lower interest rates. Usually weakens the currency.
Forward guidance	What a central bank says about its likely future decisions.

Quantitative easing (QE)	Large-scale buying of bonds by a central bank to lower long-term interest rates.
Quantitative tightening (QT)	Reducing a central bank's bond holdings, the reverse of QE.
Dot plot	A Fed chart showing where each policymaker expects interest rates to be in the coming years.
Minutes	A detailed record of a central bank meeting, published a few weeks later.

Key takeaways

1. Central banks set the policy rate, usually aiming for inflation of about 2%; the Fed also aims for maximum employment.
2. A rate change travels through bank rates and bond yields to the currency: higher rates tend to strengthen it, lower rates to weaken it.
3. Hawkish central banks favor higher rates and support their currency; dovish ones favor lower rates and weaken it.
4. Decisions are usually priced in, so currencies react to surprises and to forward guidance; the press conference can matter more than the decision.
5. The strongest trends come when two central banks move in opposite directions, as the Fed and the Bank of Japan did in 2022.

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. What is the main goal of most central banks?

- A Making the currency as strong as possible
- B Stable prices, usually inflation of about 2%
- C Keeping stock markets rising
- D Fixing the exchange rate against the dollar

2. A central bank raises its policy rate. What usually happens to its currency?

A It tends to strengthen
B It tends to weaken
C Nothing, rates do not affect currencies
D It becomes fixed

3. A policymaker says the bank is "prepared to raise rates further if needed". How would traders describe this?

A Dovish
B Hawkish
C Neutral
D Intervention

4. The market fully expects a 0.25% hike, and the central bank leaves rates unchanged. What usually happens to the currency?

A It rises, because rates did not fall
B It falls, because the decision is a dovish surprise
C Nothing, because rates did not change
D The market closes

5. Why did USD/JPY rise from about 115 to almost 152 in 2022?

A The Bank of Japan raised rates quickly
B The Fed raised rates sharply while the Bank of Japan kept its rate at −0.1%
C Japan's economy grew much faster than the US
D The yen was fixed to gold

6. What is quantitative easing (QE)?

A Raising the policy rate
B A central bank buying large amounts of bonds to lower long-term rates
C Selling the currency to strengthen it
D Printing a new currency

7. At what time is a Fed rate decision released?

A 9:00 a.m. New York time
B 2:00 p.m. New York time
C 5:00 p.m. New York time
D Midnight UTC

8. The Fed leaves rates unchanged as expected, but the chair hints at a hike at the next meeting. What is the likely reaction?

A The dollar weakens
B The dollar strengthens
C No reaction, because rates did not change
D Only gold moves

Answer key

1 B

Stable prices, usually inflation of about 2%

Most central banks aim for stable prices, usually defined as inflation of about 2% a year. The Fed also has a goal of maximum employment.

2 A

It tends to strengthen

Higher rates mean higher returns for investors, who need the currency to invest, so it tends to strengthen.

3 B

Hawkish

Talking about higher rates to fight inflation is hawkish, and hawkish comments tend to support the currency.

4 B

It falls, because the decision is a dovish surprise

The expected hike was already in the price. Leaving rates unchanged is less than expected, a dovish surprise, so the currency usually falls.

5 B

The Fed raised rates sharply while the Bank of Japan kept its rate at −0.1%

The rate gap between the dollar and the yen widened month by month, pulling money towards the dollar.

6 B

A central bank buying large amounts of bonds to lower long-term rates

In QE, a central bank buys bonds on a large scale, which lowers long-term interest rates and tends to weaken the currency.

7 B

2:00 p.m. New York time

The Fed releases its decision and statement at 2:00 p.m. New York time, followed by the press conference at 2:30 p.m.

8 B

The dollar strengthens

The guidance makes traders expect higher US rates, which supports the dollar, even though the decision itself was no surprise.

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