Interest Rates and Forex Market

The exchange rate between two currencies is determined by the interaction of several variables. Some variables have more influence on the determination of currency rates than the others. One such variable is the interest rate.

In general, **changes in the interest rate create huge fluctuations in the value of all currencies**. In fact, all major currency crises have invariably been preceded by a major change in the interest rates. Also, there are some currencies like the Eurodollar pair that are always sensitive to interest rate changes. **In this article, we will understand why interest rate changes influence the Forex market to such an extent**.

Investors Follow Highest Return

Capital inflows into and out of any country have a huge influence on the exchange rate of a particular currency. Ever since globalization has taken place, if the economic fundamentals of any country are good enough, then foreign capital seamlessly flows into that country, even if the policies are slightly restrictive. The burgeoning capital inflows into China and India can be seen as a case in point. Also, investors prefer to reinvest the returns derived from that capital in the same country further preventing currency outflow and strengthening the currency value as a result.

The interest rate that is adopted by the Central bank of a country has a huge impact on the amount of capital that flows into the country. Since foreign capital needs to be exchanged to local currency before it can be invested, a huge inflow creates a huge demand for the local currency and ends up raising its prices.

Businesses Want to Pay Lowest Cost

The flipside of having high interest rates is the fact that businesses find it difficult to borrow at that rate and still conduct profitable operations. The rate which the Central Bank determines becomes the base rate for the economy.

All businesses and individuals therefore have to pay a rate which is higher than the base rate. If the rate of return generated by the business is high enough to cover the rising interest costs and still generate profit, businesses will continue to borrow. If that is not the case, the investor funds parked in banks will have no takers and therefore the interest rates will have to fall. This will lead to capital outflows as investors will look for better avenues to park their funds. The increasing supply of the local currency without any corresponding demand will cause the Forex rates to fall further.

Therefore, rising interest rates end up being counterproductive after a certain level has been reached.

Direct Correlation Between Interest and Forex Rates

From the above points, it is apparent that there is a direct correlation between the interest rates prevalent in a given economy as well as the currency value of that economy. Therefore, if the Chinese

government raises the interest rate, then the value of the Yuan is likely to see an appreciation. This is because investors from all over the world will rush to park their funds in Chinese banks creating a huge demand for Yuan in the process.

However, the high interest rates only drive the currency value higher up to a certain point. Beyond this point, businesses start finding it unviable to raise funds at such high costs.

The real challenge is to estimate the point at which high interest rates stop attracting foreign investors and start discouraging local businesses.

Real and Nominal Rates

In the above points, we discussed nominal interest rates. However, in reality it is the real interest rate that moves markets and causes fluctuations in currency rates and not the nominal rate. Let’s say that a country has raised its interest rate to 10%. However, there is 9% inflation in the country. The real interest rate would then only be 1% and the country would not experience an appreciation in its currency despite the fact that it has a high interest rate.

Real interest rates are not published and nor are there exact numbers available. Investors have to estimate the real interest rate. However, the market does a pretty good job at this. The empirical record is crystal clear. Countries that have had high real interest rates in the past have attracted high investments and therefore have witnessed appreciation in the value of their currency.

However, a high interest rate environment cannot be artificially created unless there are enough borrowers in the economy who can profitably deploy this money borrowed at high costs for productive purposes and generate an even higher return!

Future Expectations and Not Just Current Rate

Another thing that needs to be kept in mind is the fact that markets also consider future possibilities when they set prices. Therefore, the currency rates that are prevalent in the Forex market not only reflect the interest rate environment that is present in the country at any given moment, but also reflect the possibility of interest rate changes in the future.

For instance, if there is a possibility that the Fed might cut interest rates in the future, then in all likelihood the monetary value of this possibility is already priced into the dollar.

The interaction between interest rates and exchange rates is complex and can lead to several outcomes. However, the simplified version implies a direct correlation until a ceiling is reached and beyond that tipping point, a rise creates a negative impact.