FOREX TRADING

CHANGES FOR THE FEDERAL RESERVE?

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CHANGES ON THE HORIZON?

FOREWORD

Most Forex traders understand the significance of central banks. Changes to monetary policy are one of the key drivers of currency price movements.

The world's most influential central bank is the Federal Reserve, which dictates monetary policy for the United States of America.

In the coming months, there is likely to be some significant personnel changes at the Federal Reserve. The purpose of this eBook is to explore how these changes might affect monetary policy.

Patrick Latchford
CEO, Blackwell Global Investments (UK) Limited

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THE ROLE OF CENTRAL BANKS

WHAT ARE CENTRAL BANKS?

Before we look at the Federal Reserve, let's explore why central banks are vital for Forex traders to monitor.

These institutions - which are independent of their respective governments - control something known as monetary policy. This is essentially the flow of capital within an economy.

This is important to control because the flow of capital can have a direct impact on employment, economic growth and inflation. In other words - monetary policy plays a major role in maintaining the health of an economy.

As most traders know, the health of an economy has a direct impact on the value of its respective currency. So by monitoring monetary policy changes, a Forex trader can determine whether the value of a currency is likely to increase or decrease.

Here are the central banks most traders monitor:

- The Federal Reserve (US)
- The Bank of England (UK)
- The European Central Bank (Eurozone)
- The Bank of Canada (Canada)
- The Bank of Japan (Japan)
- Reserve Bank of Australia (Australia)
- Reserve Bank of New Zealand (New Zealand)

HOW DO CENTRAL BANKS CONTROL THE FLOW OF CAPITAL?

Central banks typically have to balance key economic metrics. The first is economic growth, typically measured by GDP and the rate of employment. The second is inflation, which is the rate at which the cost of goods and services is increasing.

The goal of every major economy is to have strong GDP growth, low unemployment and a sustainable rate of inflation (typically 2%).

To control these economic metrics, central banks employ a series of monetary policy tools. Each of these tools either encourages or discourages the flow of capital.

INTEREST RATES

The most well-known monetary policy tool is interest rates. Think of this as the charge applied to private banks when they borrow money from the central bank.

Higher interest rates act to restrict the flow of capital within an economy, as they encourage businesses and consumers to save money while making it more expensive to acquire credit. This tool is often used when in inflation is too high. Higher interest rates also tend to strengthen the native currency, as they attract foreign direct investment.

Lower interest rates have the opposite effect. They are designed to encourage borrowing, making credit more affordable for both businesses and consumers. The intention here is simple: more affordable credit will encourage business investment, job growth and consumer spending. That's why lower interest rates are used to stimulate economies that are struggling to grow. Lower interest rates typically devalue the native currency, as investors shift their capital to territories with higher rates.

QUANTITATIVE EASING

Another monetary policy tool is quantitative easing. This has been used by a number of major central banks since the global financial crisis of 2008 in order to kickstart economic growth.

Quantitative easing is a process where the central bank injects capital into its country's private banking system. This usually involves the central bank purchasing bonds. By doing this, private banks have more capital to create affordable financial products for businesses and consumers.

This monetary policy tool acts to devalue the native currency, due to the laws of supply and demand.

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THE FEDERAL RESERVE

THE STATE OF PLAY

The Federal Reserve is the central bank for the United States of America. It is the world's most influential central bank because of the size of the US economy and popularity of the US dollar.

Since the election of President Trump, there has been speculation about changes to the Federal Reserve's Board of Governors. This includes chair Janet Yellen - and vice chair Stanley Fischer who announced his plans to resign in October 2017.

Before we explore the potential changes - and possible market implications - let's review the Federal Reserve's current monetary policy.

CURRENT MONETARY POLICY

The Federal Reserve is currently in a 'hiking cycle'. The central bank has increased interested rates by 0.25% on three separate

occasions since December 2016.

This has been widely anticipated by the markets as the US economy is currently in strong health. Job creation, in particular, has been consistent for the past few years. Further rate rises were anticipated for 2017.

However, since the election of President Trump, doubts about the implementation of fiscal policy (taxation and spending) has caused many market commentators to speculate whether the hiking cycle might be slowed.

Low inflation (below the Federal Reserve's target of 2%) remains a particular concern. In fact, Janet Yellen directly addressed low inflation in a recent testimony (July 2017), stating: 'it's something we're watching very closely'.

Despite this concern, most economists believe that there is a good chance of another rate hike in December 2017. Inflation data for August 2017 edged up towards the Federal Reserve's 2% target - supporting the case for another rate hike at the end of the year.

CHANGES IN PERSONNEL

While likely, traders shouldn't take a rate hike as a certainty in December 2017. Much will depend on the state of President Trump's fiscal agenda. For instance, tax reform remains a top priority for his administration.

Changes are also likely to be made to the Federal Reserve's leadership. Speculation is rife that Janet Yellen won't be offered a

second term as chair in February 2018. President Trump has the opportunity to appoint a person loyal to his administration and cause. As many have come to realise, predicting the next move of the Trump administration is notoriously difficult.

Would a change in leadership result in a change of monetary policy direction? It's difficult to determine at this moment in time - but any change in leadership at the Federal Reserve is significant.

In the meantime, we recommend that traders closely watch US inflation data. This is going to determine whether there is another rate hike in December. If a rate hike is delayed, we can expect downward pressure on the US dollar.

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