

The Role of Inflation in Forex Trading



NEWS RELEASE BY CEDARFX

Detroit, MI | March 02, 2023 01:10 PM Eastern Standard Time

Inflation levels have been hovering around their 40-year highs over the past year, as the dovish monetary policies set by the Federal Reserve during the pandemic era made borrowing extremely cheap. But surging inflation rates have had a negative impact on foreign exchange ([forex](#)) rates as they remained highly volatile over the last two years.

How Does Inflation Affect Forex?

It is essential to understand the relationship between inflation and exchange rates in order to [trade forex profitably](#). Inflation and forex have a negative relationship, as surging price levels cause an economy's currency to lose value with respect to other currencies. As the aggregate cost of goods and services rises in a country, they become uncompetitive with the global price levels. Exports take a hit during periods of high inflation, causing the demand for the domestic currency to decline in global markets.

For example, suppose a car manufactured in the U.S. and then exported to European countries has a retail price of \$50,000. As inflation has risen, retail prices have increased significantly, reaching \$60,000. A European customer might find it more economical to purchase a car manufactured and sold domestically rather than pay the inflation-adjusted price to import it from the West. So as the demand for the U.S. dollar has been used for executing the sale dries up, the reserve currency valuation plummets.

Inflation Factors That Impact Currency Trading

Inflation impacts a multitude of economic parameters including a country's gross domestic product (GDP), which, in turn, affects forex markets. Some of the most critical factors impacting currency trading are:

Gross Domestic Product (GDP)

GDP is essentially the total value of goods and services produced in a country during a particular calendar year. It is one of the most important indicators of economic activity in a country, and is

most commonly used to monitor a nation's economic growth or decline. GDP is also one of the primary macroeconomic parameters used to examine a country's overall health.

An economy's GDP typically rises during periods of inflation, as the monetary value of goods and services increases with rising price levels. But this does not necessarily indicate a positive economic performance, as dangerously high inflation levels have negative connotations. Economists generally use an inflation-adjusted GDP metric, also known as real GDP, to keep track on a country's growth.

While GDP and inflation have a positive relationship, a country's currency might depreciate even if it registers positive GDP growth. This occurs when the growth rate of inflation is higher than the nominal GDP growth rate. Monitoring the GDP levels is of paramount importance when **forex trading.**

Gross National Product (GNP)

Gross national product reflects the total value of goods and services produced by a country's residents in any given year. The most significant difference between GNP and GDP is that the former includes the monetary value of goods and services produced by a nation's residents abroad.

Like GDP, the gross national product also increases during periods of high inflation. Economists often use real GNP or GNP deflator metric to identify the actual inflation-adjusted growth rate. If the inflationary growth rate is higher than the growth in total output, the domestic currency theoretically loses value.

Consumer Price Index (CPI)

CPI is a measure of a country's inflation levels and is often termed as headline inflation. Central banks generally publish a country's CPI details every month, reflecting the inflation growth or decline. CPI has a major impact on the forex markets, as it demonstrates a currency's strength.

When CPI data is significantly different from market expectations (consensus estimates released by economists and analysts), the respective currency might witness extreme fluctuations in the **forex market.**

For instance, a high CPI figure indicates surging inflation levels, which have a negative impact on a nation's currency. But markets often expect central banks to raise benchmark interest rates when the consumer price index value surges materially, which could signal imminent currency appreciation.

Producer Price Index (PPI)

The U.S. Bureau of Labor Statistics (BLS) defines **PPI** as a “family of indexes that measures the average change over time in selling prices received by domestic producers of goods and services.” Surging PPI levels indicate inflation, thereby reducing a domestic currency’s competitiveness in the global markets.

Nonetheless, investors might interpret a rising PPI figure as an indicator that the central bank might raise rates soon, thereby raising the value of the domestic currency in the near term.

Forex Trading During Periods of High Inflation

While a currency’s value erodes under an inflationary backdrop, it is crucial to note the central bank’s response to the rising price levels before assuming a bullish or bearish stance in the forex market.

Even though the inflation level in the U.S. is still alarmingly high, the Fed hiked the benchmark federal funds rate seven times last year to mitigate surging price levels, causing the U.S. dollar to appreciate by more than 12% in 2022. The dollar also achieved dollar-euro parity for the first time since 2002 in July last year. As the Fed plans to hike rates further this year, the U.S. dollar should continue to strengthen in the upcoming months. Investors should keep up with the latest policies implemented by central banks as well as read monthly CPI reports for **forex trading**, published by agencies such as BLS.

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