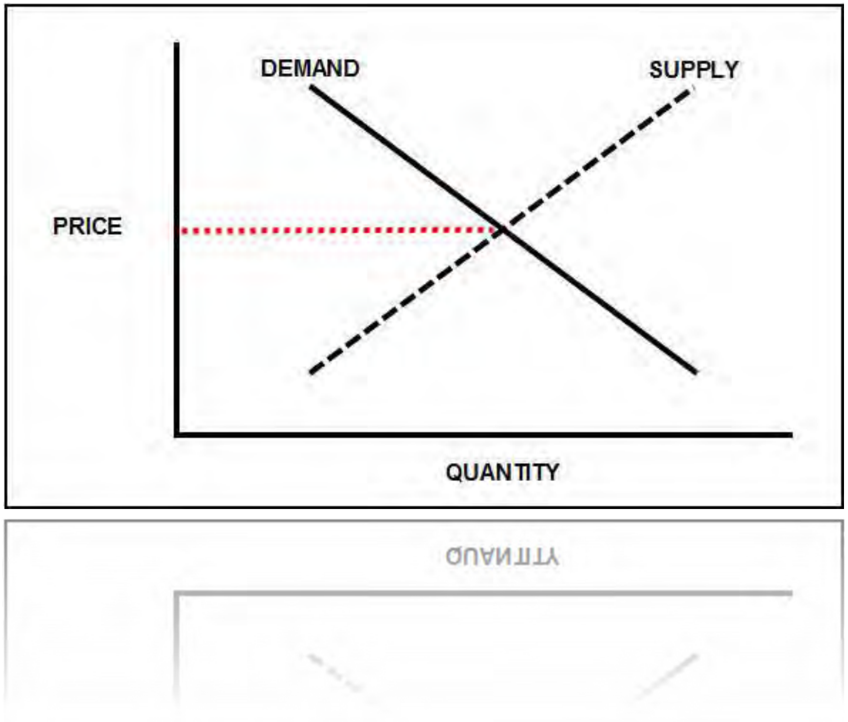
CHAPTER 3.1

Capital and Trade Flow Drive Currency Values

CAPITAL FLOW

Money crosses borders every day in ever-increasing amounts. Globalization has made it easier and easier for investors to put their money to work in virtually any economy around the globe, regardless of where they live. Investing in stocks on the New York Stock Exchange (NYSE) or the NASDAQ is just as easy as investing in stocks on the London Stock Exchange (LSE), the Frankfurt Stock Exchange or the Tokyo Stock Exchange.



Global investors have an impact on the levels of supply and demand for currencies around the world. Let's take a look at how the actions of these investors influences the value of a currency.

Here you can see a typical supply and demand chart. Demand is represented by the line that is sloping downward from left to right, and supply is represented by the line that is sloping upward from right to left. The point at which these two lines cross represents the price the market will accept for the currency.

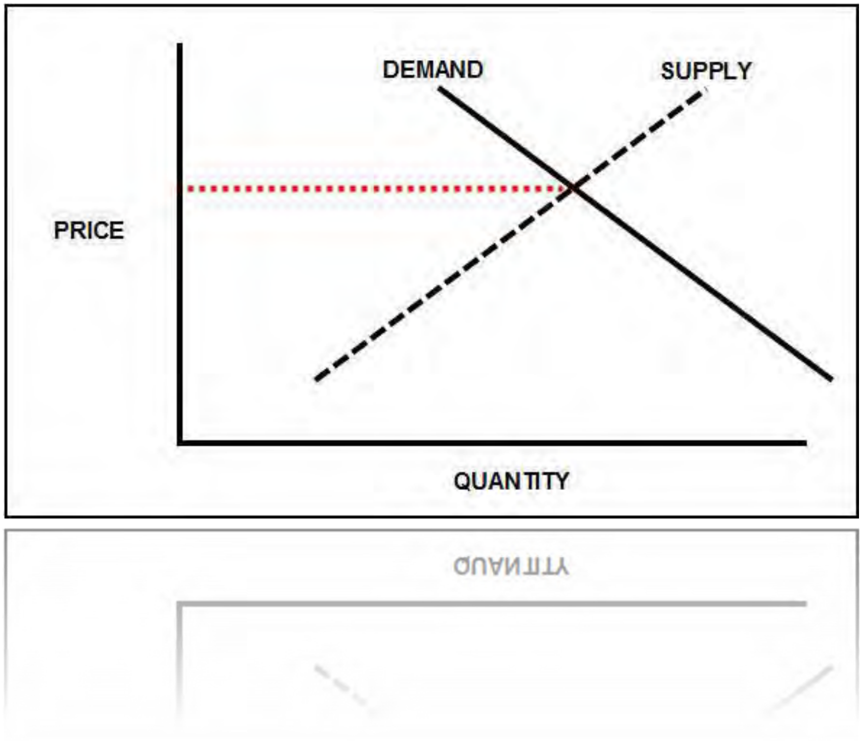
The flow of capital from one economy to another affects the currencies of the two economies involved in the exchange. Take a look at how the following can impact the value of a currency:

-	Increasing demand
-	Increasing supply
-	Decreasing demand
-	Decreasing supply

How Increasing Demand Affects Currency Values

Increasing demand for a currency increases the value of that currency.

Looking at the supply and demand chart below, you can see that as demand increases, the demand curve moves farther and farther to the right on the chart. As it moves farther and farther right, the point at which the demand curve crosses the supply curve also moves higher and higher. This tells you that increasing demand for a currency increases the value of that currency.

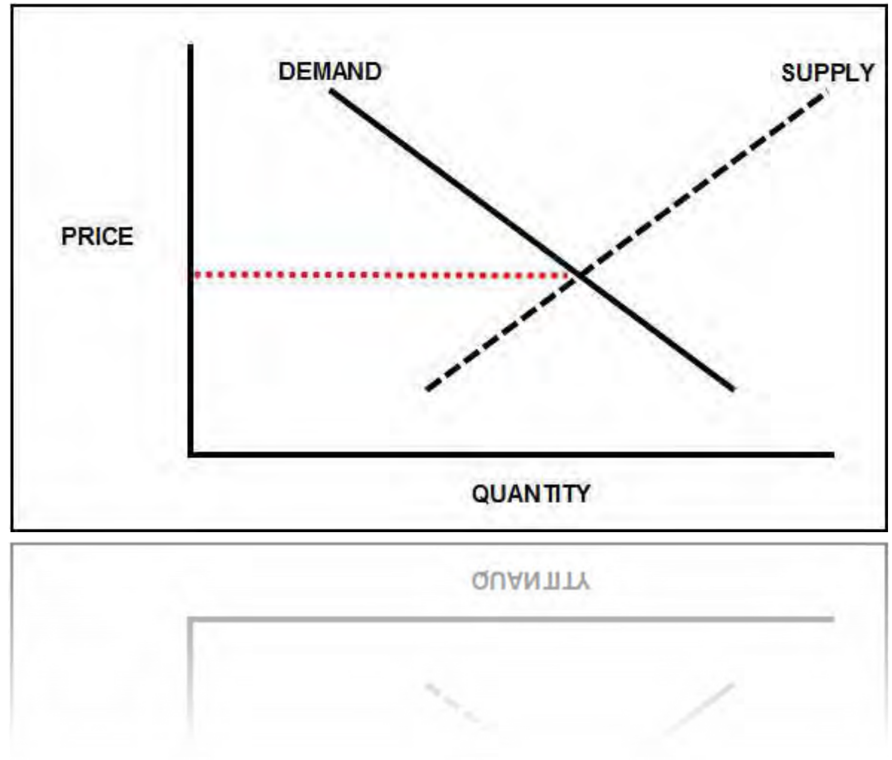


Demand for a currency increases as investors move their money from another economy into the economy represented by that currency. For example, when investors in Japan want to buy U.S. government bonds, they must exchange their Japanese yen (JPY) for U.S. dollars (USD). This increases the demand for—and thus the value of—U.S. dollars (USD).

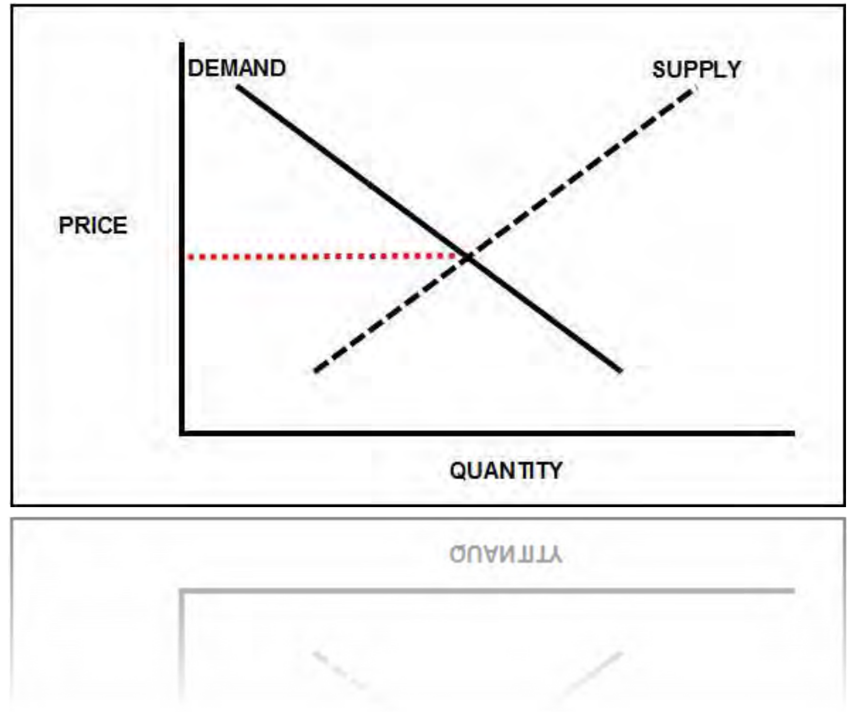
How Increasing Supply Affects Currency Values

Increasing supply of a currency decreases the value of that currency.

Looking at the supply and demand chart below, you can see that as supply increases, the supply curve moves farther and farther to the right on the chart. As it moves farther and farther right, the point at which the demand curve crosses the supply curve also moves lower and lower. This tells you that increasing supply of a currency decreases the value of that currency.



Supply of a currency increases as investors move their money from the economy represented by that currency into another economy. For example, when investors in Japan want to buy U.S. government bonds, they must exchange their Japanese yen (JPY) for U.S. dollars (USD). This increases the supply of Japanese yen (JPY), which decreases their value.

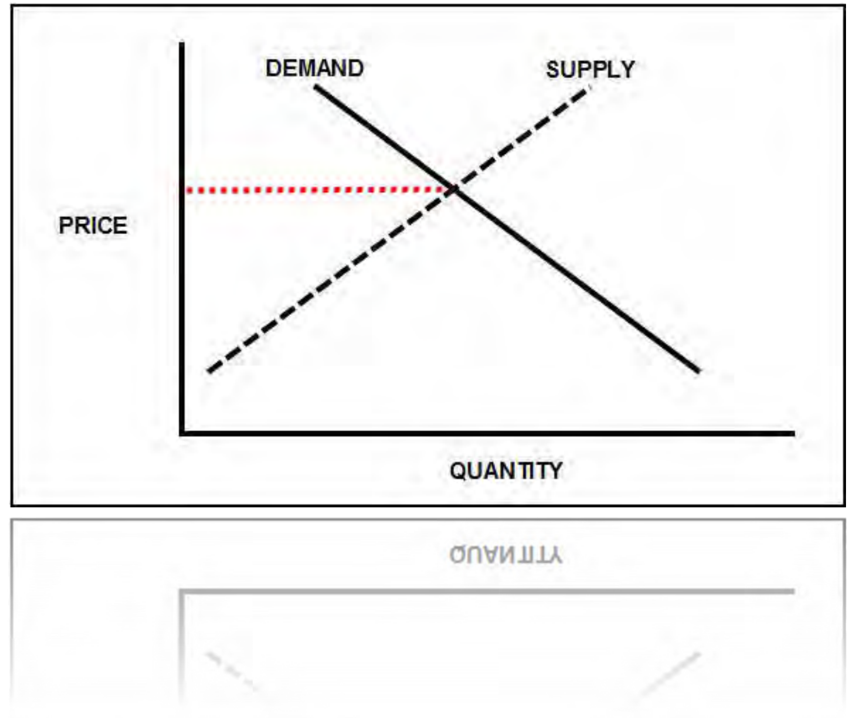


How Decreasing Demand Affects Currency Values

Decreasing demand for a currency decreases the value of that currency.

Looking at the supply and demand chart below, you can see that as demand decreases, the demand curve moves farther and farther to the left on the chart. As it moves farther and farther left, the point at which the demand curve crosses the supply curve also moves lower and lower. This tells you that decreasing demand for a currency decreases the value of that currency.

Demand for a currency decreases as investors stop moving their money from other economies into the economy represented by that currency. For example, when the Bank of England (BOE) lowers interest rates, U.K. government bonds become less appealing to foreign investors because they offer a lower rate of return. If foreign investors do not want to buy U.K. government bonds, they do not need to exchange their currency for British pounds (GBP). This decreases the demand for—and thus the value of—British pounds (GBP).



How Decreasing Supply Affects Currency Values

Decreasing supply of a currency increases the value of that currency.

Looking at the supply and demand chart below, you can see that as supply decreases, the supply curve moves farther and farther to the left on the chart. As it moves farther and farther left, the point at which the demand curve crosses the supply curve also moves higher and higher. This tells you that decreasing supply of a currency increases the value of that currency.

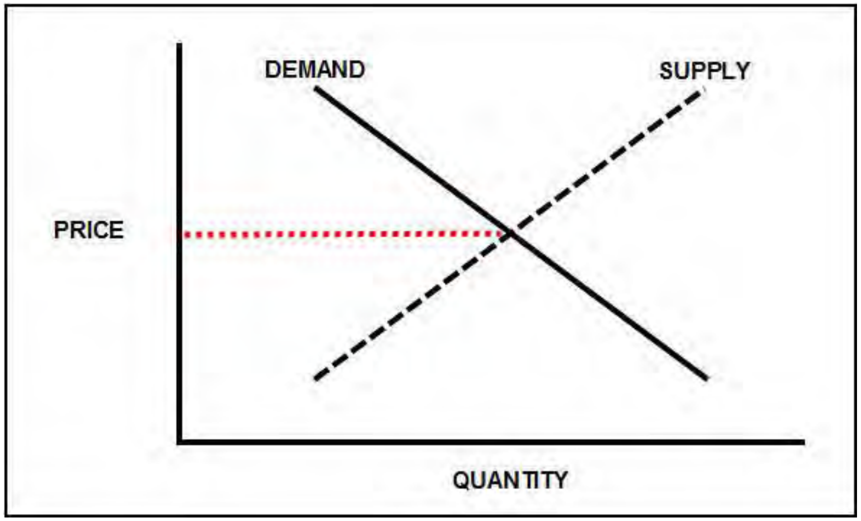
Supply for a currency decreases as central banks increase reserve requirements to pull money out of circulation. For example, when the U.S. Federal Reserve increases reserve requirements for its member banks, it tells them that they must keep more of their money in reserve instead of lending it to borrowers. This makes it more difficult for corporations and individuals to borrow money, which effectively reduces the amount of money that is in circulation.

Trade Flow

Chances are if you look at the electronics, toys and clothing you bought during this past year, you will find they were made somewhere outside of the country you live in. Global trade has blossomed, and it is now possible for virtually anyone to eat bananas from South America on dishes from Europe while watching a television made in China.

Trade flow between economies affects currency values. Every time goods or services exchange hands, money also has to exchange hands. European importers have to exchange money to buy goods from Japanese exporters just as Japanese importers have to exchange money to buy goods from European exporters. Each time importers exchange money, it affects the supply of and demand for the currencies of the two economies involved—and supply and demand drive currency prices.

Here you can see a typical supply and demand chart. Demand is represented by the line that is sloping downward from left to right, and supply is represented by the line that is sloping upward from right to left. The point at which these two lines cross represents the price the market will accept for the currency.



Take a look at how the following can impact the value of a currency:

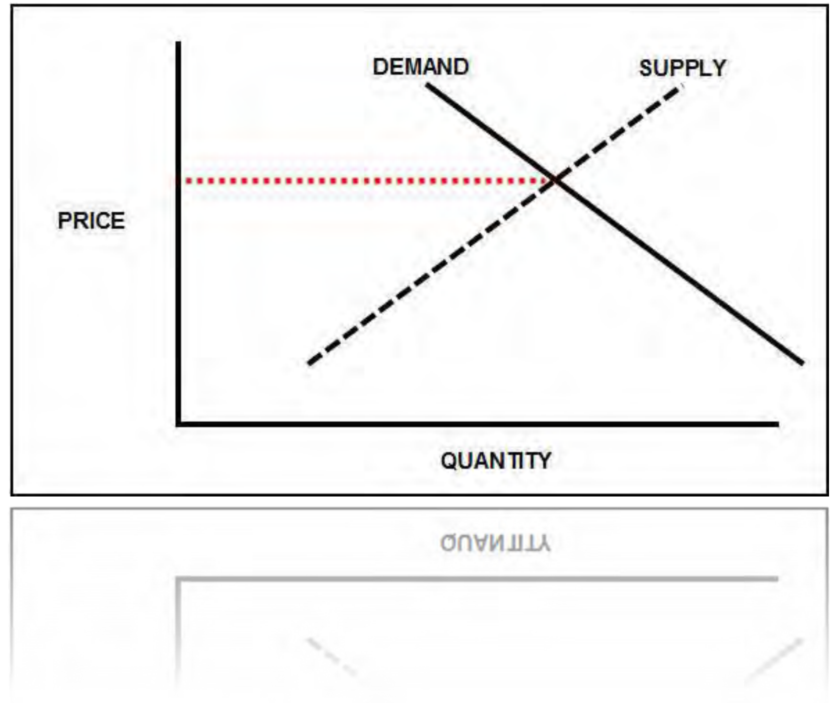
-	Increasing demand for the exporter’s currency
-	Increasing supply of the importer’s currency

Plus, you can monitor what affects trade flow may be having on the currencies you are trading by watching perhaps the most important trade-based fundamental economic indicator: trade balance.

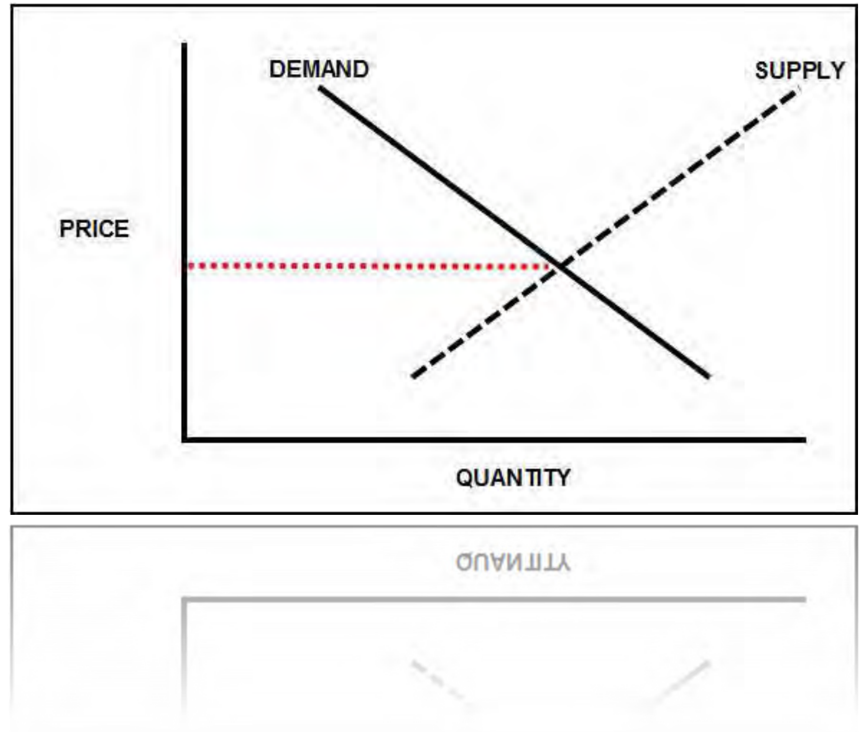
How Increasing Demand from Importers Affects Currency Values

Increasing demand for a currency increases the value of that currency.

Looking at the supply and demand chart below, you can see that as demand increases, the demand curve moves farther and farther to the right on the chart. As it moves farther and farther right, the point at which the demand curve crosses the supply curve also moves higher and higher. This tells you that increasing demand for a currency increases the value of that currency.



Demand for an exporter's currency increases as importers from one economy buy goods and services from exporters from another economy. For example, when importers from the U.S. want to buy goods from Japan, they must buy those goods in Japanese yen (JPY). In other words, U.S. importers must buy Japanese yen (JPY) so they can buy Japanese goods. This increases the demand for—and thus the value of—Japanese yen (JPY).



How Increasing Supply from Importers Affects Currency Values

Increasing supply of a currency decreases the value of that currency.

Looking at the supply and demand chart below, you can see that as supply increases, the supply curve moves farther and farther to the right on the chart. As it moves farther and farther right, the point at which the demand curve crosses the supply curve also moves lower and lower. This tells you that increasing supply of a currency decreases the value of that currency.

Supply of an importer's currency increases as importers from one economy buy goods and services from exporters from another economy. For example, when importers from the U.S. want to buy goods from Japan, they must buy those goods in Japanese yen (JPY). To obtain the money to buy Japanese yen (JPY), U.S. importers must first sell U.S. dollars (USD). They can then use the proceeds from the sale of their U.S. dollars (USD) to buy Japanese yen (JPY). This sale of U.S. dollars (USD) increases the supply of—and thus decreases the value of—U.S. dollars (USD).

Trade Balance

The trade balance is a measure of the difference between imports and exports of tangible goods and services. The level of the trade balance and changes in exports and imports are widely followed by foreign exchange markets.

The trade balance is a major indicator of foreign exchange trends. Seen in isolation, measures of imports and exports are important indicators of overall economic activity in the economy.

It is often of interest to examine the trend growth rates for exports and imports separately. Trends in export activities reflect the competitive position of the country in question, but also the strength of economic activity abroad. Trends in import activity reflect the strength of domestic economic activity.

Typically, a nation that runs a substantial trade balance deficit has a weak currency due to the continued commercial selling of the currency. This can, however, be offset by financial investment flows for extended periods of time.

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