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# Impact of Interest Rates on Financial Markets [Forex, Stocks, Gold and Crypto]

Categories: [Forex Education](#) [Fundamental Analysis Education](#)

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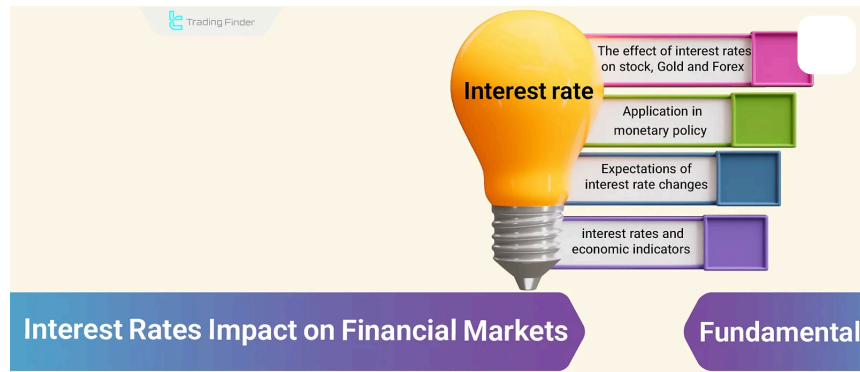


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**Interest rates** are a key tool for central banks to implement **monetary policy**, and **changes interest rates** create significant fluctuations in financial markets.



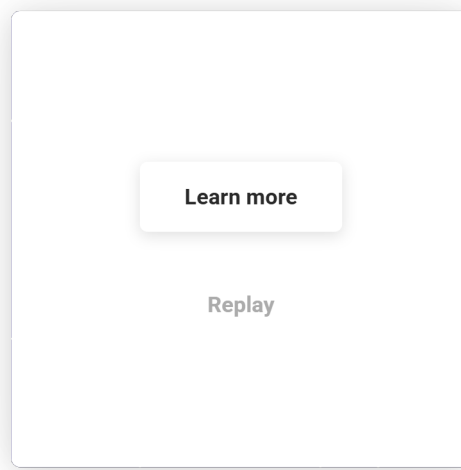
Changes in interest rates, by increasing or decreasing liquidity levels, directly affect exchange rates and other financial markets

Typically, **increasing interest rates** leads to **currency strengthening**, while **decreasing interest rates** causes **currency weakening**. Additionally, **expectations** of interest rate changes also influence the market.

## Why Are Interest Rates Important in Financial Markets?

Changes in interest rates play a crucial role in financial markets because they directly impact inflation, economic growth, and unemployment rates. Changes in these factors lead to either the strengthening or weakening of currencies.

According to academic definitions, **interest rates** can be defined as the "**value of money**"; the interest rate is the **cost of borrowing money**. This means the borrower must repay the borrowed amount plus the **interest rate** or **borrowing cost**.



For example, assume the **interest rate** is **5%**, and you borrow 1000\$. In this case, you must repay 1000\$ **plus 5% of it (50\$)**. Actually, the 50\$ is the **cost of borrowing**.

To monitor interest rates of various economies, you can use TradingFinder [interest rate tool](#).

## The Interest Rate Impact on Economic Trends and Indicators

**Changes in interest rates** affect **liquidity, consumer demand,** and **economic growth**. Increasing interest rates reduces inflation and economic growth, acting as a constraint on the economy. Conversely, lowering borrowing costs supports economic growth, but it may also lead to increased inflation.

The table below shows the relationship between **interest rates** and key **economic indicators**:

Indicators	Result of Lowering Interest Rates	Result of Increasing Interest Rates
Inflation	Increase	Decrease
Economic Growth	Increase	Decrease

Unemployment Rate	Decrease	Increase
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You can track economic reports from the [economic calendar](#) on the TradingFinder website.

## The Relationship Between Interest Rates and Inflation

Decreasing or increasing interest rates directly affects **liquidity** and **inflation**. Lower borrowing costs increase liquidity, leading to higher consumer demand, resulting in increased inflation.

Additionally, according to the **monetary root of the inflation formula**, if the **money supply** exceeds the supply of **goods**, inflation occurs.



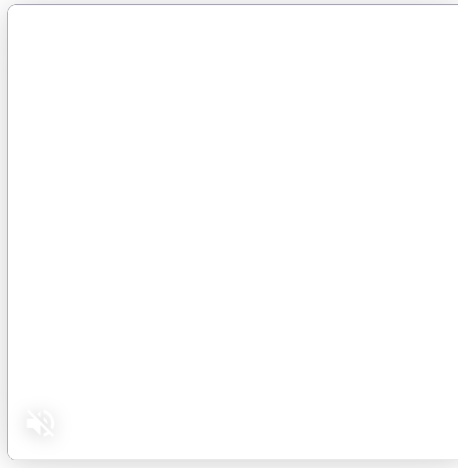
Conversely, **increasing borrowing costs** reduces liquidity, and limits **demand**, and lower demand leads to reduced inflation.

## The Relationship Between Interest Rates and Economic Growth

According to the **expenditure approach** in calculating **GDP** (Gross Domestic Product), **demand** is one of the factors influencing economic growth.

Any action that suppresses **demand**, such as increasing interest rates or reducing liquidity, leads to a decline in economic growth. Conversely, any action that stimulates

demand, such as lowering interest rates or increasing liquidity, boosts economic growth.



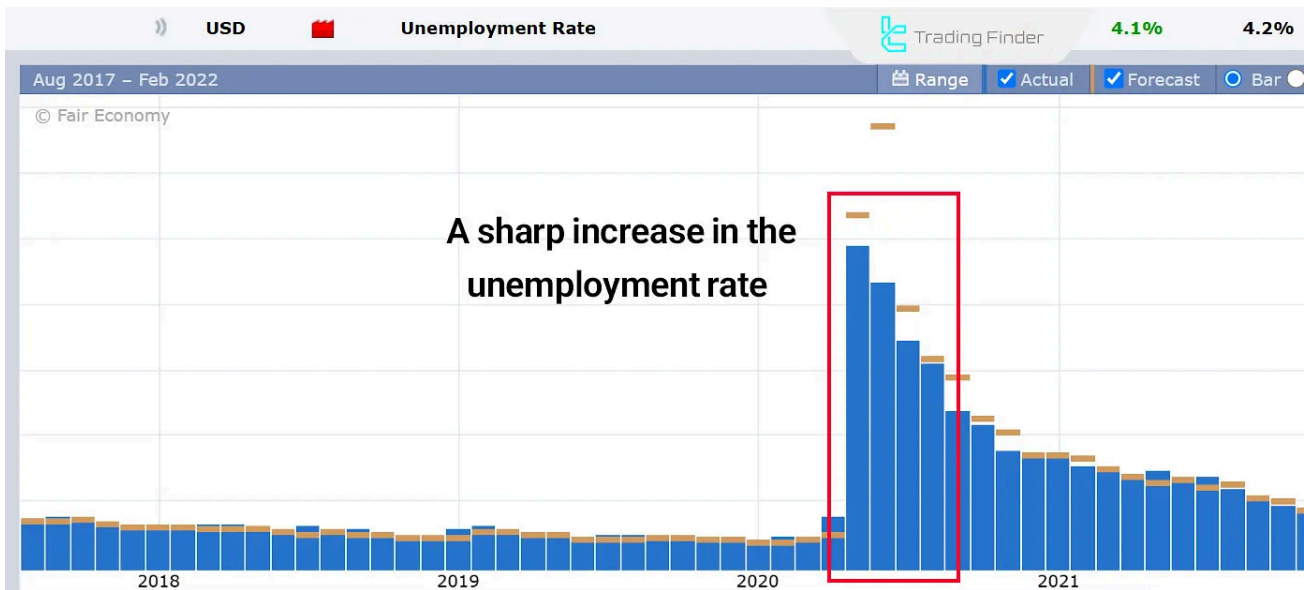
**Note:** The **expenditure approach** in calculating GDP is based on the following factors:

- ⚡ **Trade Balance**
- ⚡ **Government Expenditures**
- ⚡ **Consumer Demand**
- ⚡ **Investment in Productio**

## The Relationship Between Interest Rates and Unemployment Rates

The **unemployment rate** has an inverse relationship with **economic growth**; Increased economic growth leads to a lower unemployment rate.

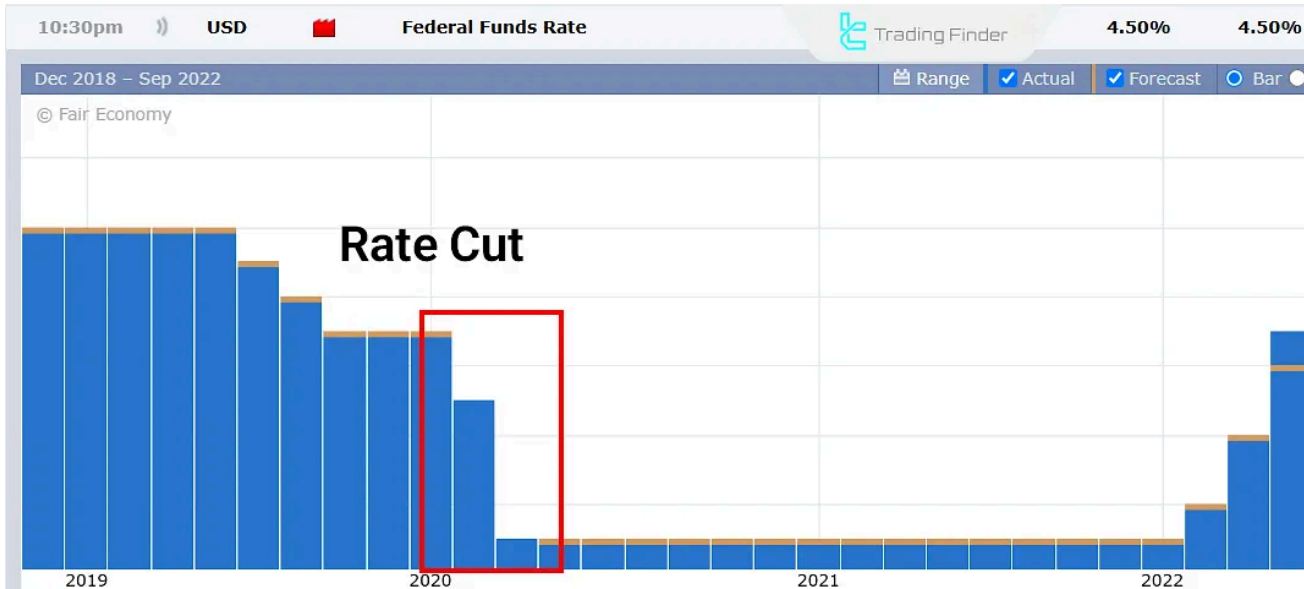
Thus, lowering borrowing costs and increasing liquidity is effective in reducing the unemployment rate. Conversely, increasing borrowing costs and putting pressure on producers leads to a higher **unemployment rate**. **Example of rising unemployment due to increased borrowing costs:**



A sharp increase in the unemployment rate

This image shows the sharp increase in the US unemployment rate in the first half of 2020; Source: Forex Factory

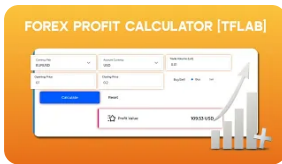
At the **beginning of 2020**, following the onset of the COVID-19 pandemic, the US **unemployment rate** increased sharply (image above). To combat the **recession** and **reduce unemployment**, the Federal Reserve lowered **interest rates**, as shown in the image below.



Rate Cut

The reduction in US interest rates at the beginning of 2020 to counter the COVID-19 shock; source: Forex Factory

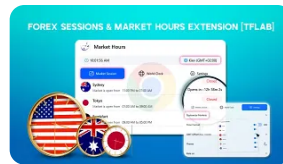
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## What Factors Influence Changes in Interest Rates?

Implementing changes and setting interest rates is the responsibility of the **central bank**. Considering their **dual mandate** (controlling **unemployment** and **inflation**) and monitoring economic data, central banks adjust interest rates.

**Central banks consider the following data when setting interest rates:**

- ⚡ **Inflation:** If inflationary pressures are felt in the economy, the central bank will raise interest rates to control inflation (contractionary monetary policy);
- ⚡ **Unemployment Rate:** If the unemployment rate rises, the central bank lowers interest rates to stimulate the economy and reduce unemployment (expansionary monetary policy).

## Impact of Interest Rates on Financial Markets

Changes in interest rates lead to changes in exchange rates, thereby influencing stock, commodity, and **Forex market**.

### The Effect of Interest Rates on Forex

As the money supply increases, the currency's value decreases; Conversely, as the money supply decreases, the currency's value increases.

According to this principle, increasing borrowing costs strengthens the currency. Conversely, lowering borrowing costs weakens the currency.

### Interest Rate Impact on the Stock Market

The effect of interest rates on the **stock market** is such that increasing borrowing costs suppresses **demand**, making it harder to obtain loans, and putting pressure on producers.

Thus, during periods of **contractionary policy** or increased borrowing costs, the stock market moves away from **prosperous days**.

## The Effect of Interest Rates on Gold

Gold, [the long-standing competitor to fiat currency], is affected by changes in interest rates. Increasing interest rates leads to a correction in gold prices, while decreasing interest rates causes gold to rise.

**Note:** The effect of interest rates on gold appears in the long term, and other factors also influence gold's trend.



Despite rising interest rates in 2023 and 2024, gold experienced a strong upward trend; Source: TradingView

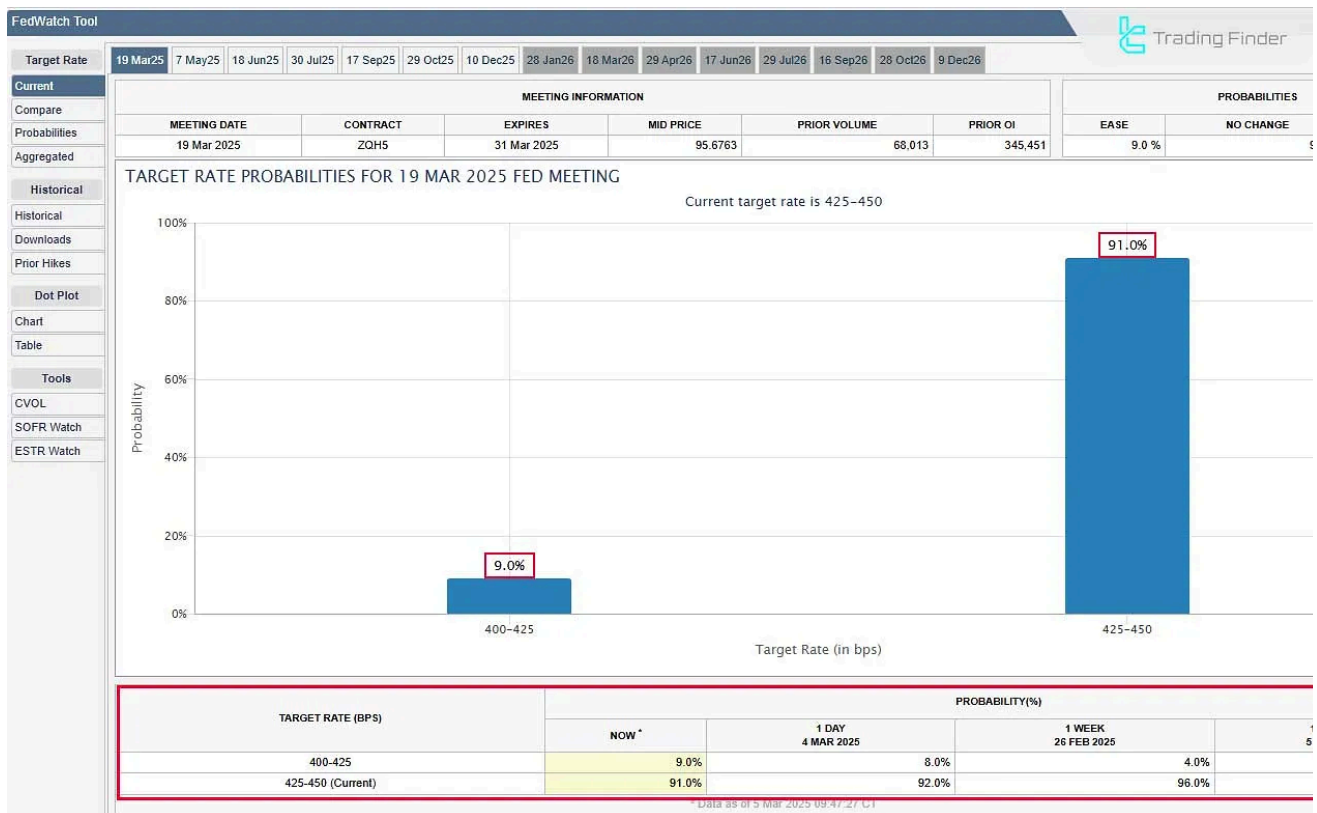
Gold's trend in 2023 and 2024 was driven by **geopolitical tensions**, proving that rising interest rates alone cannot determine the trend.

# Expectations of Interest Rate Changes in Forex

Currencies will strengthen if market participants expect an interest rate hike during the upcoming central bank meeting. **Impact of Interest Rate Changes on Forex:**

- ⚡ **Expectations of Rising Interest Rates:** Strengthen the related currency and increase **risk aversion** in the market;
- ⚡ **Expectations of Falling Interest Rates:** Weaken the related currency and increase **risk appetite** in the market.

**Expectations of US interest rate changes** can be viewed on the **CME FedWatch Tool** website.



The CME FedWatch Tool shows market expectations for Federal Reserve interest rate changes;  
Source: CME FedWatch Tool

This image from the **CME FedWatch Tool** shows that, at this moment, 91.0% of the market expects interest rates to remain unchanged during the upcoming Federal Reserve meeting.

## Example of the Impact of Interest Rate Expectations on the Market

As shown in the image below, with changes in market expectations for an interest rate hike by the **BOJ** (Bank of Japan), the Japanese yen has been significantly affected.

When the market expects an interest rate hike, the yen strengthens. However, when interest rates are expected to remain unchanged, the yen weakens.



The impact of BOJ interest rate hike expectations on the EURJPY trend is evident; Source: TradingView

## Conclusion

**Increasing interest rates** limits **economic growth** by reducing **liquidity** and is a **contractionary policy** that strengthens currency.

Conversely, **lowering interest rates** increases **liquidity**, stimulates **economic growth**, and is an **expansionary policy**. This action leads to **currency weakening**.

By monitoring **market expectations** for interest rate changes, the direction of currency pairs can be predicted.

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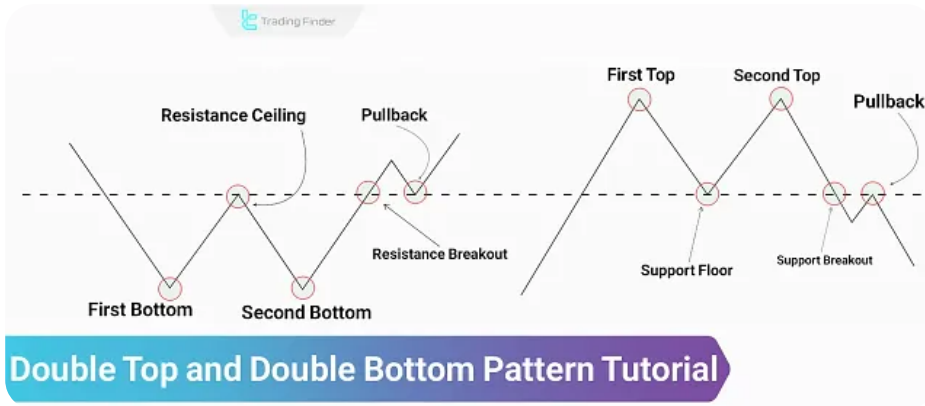
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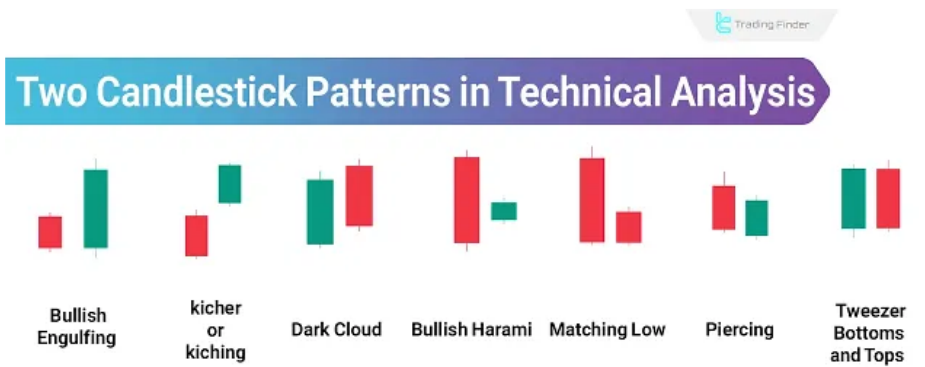


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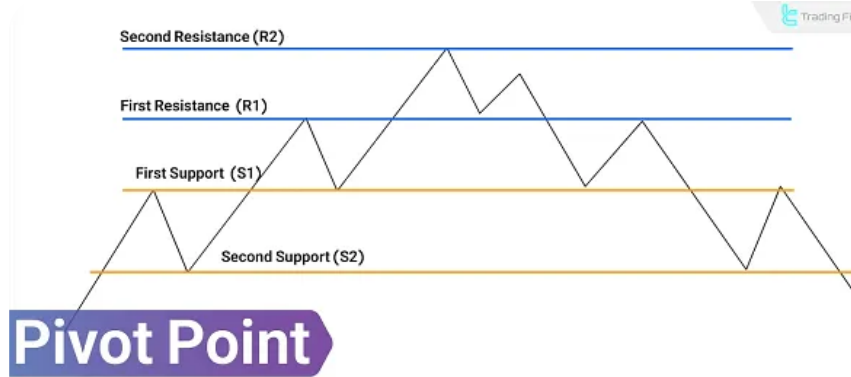
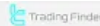
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