Guide to Foreign Exchange Done Right!

How Foreign Exchange Works

An exchange rate shows how much your money is worth in a foreign currency. Exchange rates are constantly changing.

There are essentially two foreign exchange markets:

- ❖ Retail/Cash Market (i.e. money used for smaller, shorter term needs (e.g. - tourism)
  - ➢ ATMs
  - ➢ Specialist currency providers
  - ➢ Commissions are common
- ❖ Wholesale Market
  - ➢ Specialist providers (e.g. AFEX)
  - ➢ Where people move their life savings from one country to another, resulting in generally much larger denominations

What is the Interbank Rate & The Importance of the Spread

The “interbank rate” refers to the foreign exchange rate paid by banks when trading currencies with other banks. It also happens to be the lowest rate available at any particular time, and it is reserved specifically for large banking institutions. Individual forex transactions have a “spread” built in. The “spread” is the difference between the forex rate you pay and the interbank rate. Foreign exchange providers make money off the spread and/or by charging a commission.

What is Meant by the Strength of a Currency?

The strength of a currency is the value of a currency compared to a basket of other currencies (e.g. US Dollar Index DXY). But, for foreign exchange transactions, we only care about the pairwise relationship to a ***particular*** currency (e.g. AUD/USD).

What makes a currency strong? → ‘demand’ for that currency, driven by;

1. The country’s interest rates relative to others
2. Inflation, government debt, and political and economic stability

Drivers of the USD/AUD Relationship

The main determinants in the value of the AUD/USD, include:

1. Interest rate influences
2. Commodity exports
3. Near term economic forecast

4. Economic and political relationships with trading partners

A Well-Considered Foreign Exchange Strategy

1. **Familiarity:** Get a feel for the foreign exchange rate (especially in the last ~24-36 months) and understand the drivers in the pairwise combination. Correlate the direction of the exchange rate with the relative change in the central bank interest rates in the two countries.
2. **Clarity on Departure Date and Short Term Goals:** Being clear on your departure/arrival date and your short term financial goals upon arriving (e.g. buying a car, rental deposit) will inform the decision as to how much money you will need upon your arrival.
3. **Timeframe of Medium Term Goals:** Know the timeframe over which you need your funds available in your foreign currency (e.g. 1 - 3 years, etc) to achieve medium term goals (e.g. buying a house). This may also influence your conversion frequency.
4. **Form a View:** What differences are their interest rates? What differing economic prospects are there? Where do you see the rates trending over time?
5. **Establish a Periodic Transfer Schedule:** With an eye on the historic rate relationship → Set up a plan for periodic transfers.
6. **Venue**: Choose the appropriate venue for exchange to get the best spread. For client's performing a limited number of transfers and/or not requiring ongoing investment management services, we would recommend an institutional conversion service such as AFEX. For client's transferring larger sums who would benefit from an ongoing multi-currency brokerage account, we recommend Interactive Brokers.
7. **Risk Management:** Investigate active currency risk management strategies (forwards, option strategies).