



## Guide To...

### Exchange Rates & Currency Management

#### ***What are Exchange Rates?***

An exchange rate is simply the price of one currency in terms of another. For example, suppose that a supermarket is selling apples for \$2/apple. This means that \$2 will buy 1 apple. Similarly, an exchange rate of AUD/0.66USD means that 1 Australian dollar will buy 0.66 US dollars. Usually in the Australian press or media, this will be reported as the AUD/USD exchange rate being 0.66. Conversely, in the US press or media, this exchange rate would generally be reported as the USD/AUD exchange rate being 1.52. This means that 1 US dollar will buy 1.52 Australian dollars.

#### ***What determines the price of a currency?***

The way that the price of a currency is determined depends on the particular exchange rate mechanism adopted. This mechanism can be either 'fixed' or 'floating'. 'Fixed' (or 'managed') currencies are maintained by the government or central bank at a level that they deem appropriate. 'Floating' currencies fluctuate with the relative supply and demand in the foreign exchange (FOREX) markets. This is similar to an auction, where the demand from buyers and the supply from sellers determine the price of an object. In the case of a floating exchange rate, the object being "auctioned" is a currency such as the Australian dollar. The Australian dollar has operated under a floating system since December 1983. Floating exchange rates fluctuate continuously, sometimes changing dramatically in months, weeks or days. Anything that affects the demand or supply of a currency will affect its exchange rate. Exchange rates are influenced by the fundamental factors of an economy such as inflation, interest rates and productivity. These fundamentals drive trading and investment activity, which generates the supply and demand of a currency and hence its price.

#### ***Why do investors care about exchange rates?***

Investors that are invested overseas, either directly or via an international fund, will be affected by exchange rates. This exposure to the exchange rate is known as currency risk. For example, Australian investors that hold international shares (either directly or via an international share fund) will be adversely affected by a strengthening of the Australian dollar against other international currencies. This is essentially because international investments/assets on international funds are in international currencies, which must be converted back into Australian dollars. If the Australian dollar strengthens against these international currencies, then international returns will be worth less in Australian dollars. This means that the Australian investor will be worse off when the international currency returns are converted into Australian dollar returns. The opposite effect occurs if the Australian dollar weakens against other international currencies.

Some international share funds employ hedging to manage this currency risk. Hedging involves the use of derivatives and other strategies to 'lock in' a particular currency return. A fund manager that employs hedging may either fully hedge their portfolio or partially hedge their portfolio. For example, consider an Australian investor holding an international share fund that is fully hedged against an increase in the value of the Australian dollar.

This investor will be protected from the appreciation in the Australian dollar, notwithstanding changes in the value of the underlying assets (ie. assuming all else remains constant). In contrast, if the international share fund was only partially hedged, then the investor will typically still be worse off in Australian dollar terms, albeit not as severe as an unhedged fund. However, hedging prevents the fund from benefiting from favourable movements in the currency. For example, if an Australian investor holds an unhedged international share fund and the Australian dollar weakens, then the Australian investor will typically be better off in Australian dollar terms. This is because the returns are in international currencies, which convert into more Australian dollars and hence the Australian investor will be better off in Australian dollar terms.

Note that predicting currency movement is very difficult if not impossible. Currencies can remain under or over valued for long periods of time and are influenced by a myriad of factors. It should be noted that investors holding shares only in Australian companies might still be indirectly exposed to currency risk. If the Australian company has operations or customers overseas, then the company will be affected by movements in the exchange rate. For example, if the Australian company has operations in the US, then the revenues from those operations must be converted from US dollars to Australian dollars. An appreciation in the Australian dollar results in the international revenues converting into lower Australian dollar revenues. Depending on the nature of the business and how the company manages their currency risk, this may have a negative impact on the share price and returns for the investor.

### ***Why do companies care about exchange rates?***

As mentioned above, companies that have overseas operations are affected by the exchange rate, as the revenues earned from those overseas operations must be converted back into their home currency. Additionally, the exchange rate affects the relative prices of goods sold to other countries (exports) and the prices of foreign goods sold in the home market (imports). For example if the Australian dollar depreciates, then its exports will be cheaper for foreigners to buy (because the foreigner's currency is now worth relatively more). This means that exporting companies will be more competitive internationally and revenues earned from overseas sales will tend to increase. Conversely, if the Australian dollar appreciates, then the company's exports will be more expensive for foreigners to buy (because the foreigner's currency is now worth relatively less). This means that exporting companies will be less competitive internationally and revenues earned from overseas sales will tend to decrease.

### ***Why does the government care about exchange rates?***

The most immediate effect and concern for the government is the effect that the exchange rate will have on inflation. For example, a fall in the Australian dollar means that imports become more expensive and this allows domestic producers to raise prices as well. Theoretically, the weaker Australian dollar may result in higher prices (inflation), which is a concern to the government. However, as we shall see next, it may also help a country recover out of a weak economic condition, without increasing inflation. The exchange rate affects the trade balance of a country (amount of exports relative to imports). The trade balance is an important component of a country's G.D.P. (Gross Domestic Product) and economic growth.<sup>1</sup> For example, a fall in the Australian dollar means that imports become more expensive, as we mentioned previously.

Additionally, exports become cheaper for foreigners to buy, increasing demand for Australian products worldwide. Broadly speaking, this tends to create a trade balance surplus (ie. exports are greater than imports) and stimulates the Australian economy. In theory, this stimulating of the economy would also contribute to higher inflation. However, in some cases this stimulus helps a country strengthen their trade position and recover out of a weak economic condition, without increasing inflation. This was seen in Australia following the 1997-1998 Asian crisis, where the weaker currency did not result in higher inflation.

*If you have any queries in relation to the content of this material, please do not hesitate to contact Kate Kimmorley the Principal Financial Adviser at Kimmorley Financial Management on (07) 5591 1725.*

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