

Foreign Currency: It isn't the Stable Investment We Think

Most people assume the strength of a country's currency is based on market forces, mainly economic factors, alone. The assumption is that a stable economy would yield better currency strengths relative to others.

Actually the strength of each country's currency is based purely on the state of its economy and political stability. Accordingly, foreign currency is the most volatile investment; it can experience price changes by the split second. It is also the largest trade volume transaction in the world. These facts make investing in foreign currency a very risky business.

The factor that most strongly influences a currency's strength is the political will of the country. Not convinced? Let's take Singapore as an example. You may or may not know that Singapore enjoys a stable, developed, relatively strong economy. It is debt free with plenty of reserves. But

despite the country's enviable economy, Singapore's currency declines in correlation with the US dollar. Between April 2009 and October 19, 2009 the Singapore dollar experienced a drop of 9.15%, compared to the Canadian dollar. This substantial change occurred within a 6 month period! This is because Singapore is a trading country with a limited domestic market; consequently, in order to remain competitive in foreign trade it must lower its exchange rate relative to its main trading partners.

Even Canada has recognized the need to keep its currency down to maintain good business. Over the last 6 months the loonie experienced a 19% appreciation compared to the US dollar. Fearful of what this might mean for its international relationships, the Canadian government hinted that it might need to take action to stop the rise of the loonie. A soaring Canadian dollar would hurt both our economy and our fragile recovery from the recent recession.

And look at Switzerland. It has a pretty stable economy; it is comparable to that of Canada. Yet its exchange rate fluctuated from 0.94 to 0.985 between April and October 15, 2009.

So we see that there is more at work here than market forces. But why do foreign governments prop up the US dollar? Because most of them have foreign reserve in US currency. Do you think the Chinese want the US dollar decline to wipe out their \$4 trillion in USD assets? Of course not.

The truth is the fluctuations experienced in the trade of foreign currency are closely tied to the trade and political wills of government bodies. Investors simply can't keep up with the interplay of political powers, the trade issues and the economic, fiscal and monetary policies of the various foreign governments, so investing in their currencies carries too much risk. Due to foreign currency fluctuations, foreign investment returns could quickly erode and end up in the red.

