One bank is exhorting that you can "earn 8X more interest* with an AUD time deposit". As is with many banking products, there is an asterisk embedded within the clause. What's the catch?

Allure of the Australian Dollar

As a result of the strong demand for its commodity exports, Australia was [one of the first economies to raise interest rates] while most of the rest of the world are still keeping interest rates low to boost post-recession consumption. Australian dollar deposits now earn far higher returns than those of other major currencies.

HSBC is offering 3.5% per annum in interest for a minimum A$25,000 12-month fixed deposit (also known as a time deposit) while a similar Singapore dollar fixed deposit pays only 0.48% at the same bank.{loadposition advert1}

Not to be outdone, DBS also markets a "Currency Linked Investment" which allows DBS Treasures clients to "Enjoy Potential Returns of Up to 8.8% p.a." for short-term (2-week and 1-month tenor) investments linked to the Australian dollar.

However, investing in foreign currencies involves a substantial amount of downside that is not always made clear to the investor, as in the case of the HSBC advertising campaign.

Spread

One of the ways that banks earn fees is from selling a currency for a higher price than it pays for it. The difference between the buy and sell prices is known as the spread.

On 23 Apr 2010, HSBC is selling one Australian dollar (AUD) for 1.2844 Singapore dollars (SGD) and buying 1 AUD for 1.2484 SGD. This means that upfront the depositor immediately loses 1.4% when commencing the AUD deposit and would stand to lose another 1.4% when he redeems the deposit in Singapore dollars. The spread is effectively 2.8%.

Therefore, assuming that the Australian dollar remains stable compared to the Singapore dollar during the term of a one-year fixed deposit, a depositor would effectively get a return of only 0.7% (3.5% interest subtracted by the spread of 2.8%), far less than the 3.5% headline rate.

Foreign Exchange Fluctuations

Currency exchange rates do not always stay constant and volatility is a key risk factor which may wipe out whatever gains that a depositor may have left after subtracting the spread. We do not have to look far back in history for such a scenario. In August 2008, each Australian dollar traded at about S$1.30. Within two months, the Australian dollar had plunged nearly 25% to reach parity against the Singapore dollar and did not recover to its previous level until November 2009.

The Monetary Authority of Singapore has recently made known that in order to counter inflationary pressures, the Singapore dollar will be allowed to gradually appreciate against the currencies of major trading partners. While it is difficult to predict the future AUD-SGD exchange rate, there is a fair chance that depositors would face to a weaker Australian dollar by the time their deposits reach maturity.

Early Redemption Penalties

As in all fixed deposits, redemption before the tenor expires can lead to prohibitive penalties which are often set at the discretion of the banks. However, unlike regular Singapore dollar fixed deposits, the early redemption of a foreign currency fixed deposit will very likely result in the partial loss of the principle sum due to the combined effects from the early redemption penalty and spread charges. This is why foreign currency fixed deposits are in practice not as liquid as local currency deposits.

Conclusion

To successfully invest in a high-interest foreign currency fixed deposit, one generally has to be very confident that the target currency will appreciate. Alternatively, he must be open to commit to a sufficiently long investing horizon to ride out gyrations in exchange rates and allow the spread charges to be averaged out over several years.

Most importantly, for sophisticated products such as the DBS Currency Linked Investment, investors should always read the fine print beyond the eye-catching headline that promises a much more attractive return than a Singapore dollar fixed deposit.