Session Objectives

- Review the fundamental causes and consequences of exchange rate fluctuations
- Identify situations that would lead to exchange rate risk
- Establish learning goals for your situation
- Discuss appropriate strategies to achieve your goals

Introduction

- Understanding trade finance is an important part of both the CGBP exam and successful management of trade within firms
- US companies often avoid dealing with trade finance issues by selling in US dollars and expecting to get paid in advance which limits potential transactions
- The Department of Commerce's Trade Finance Guide is an excellent resource and overview of the range of issues and products to manage risk in trade finance

The Spot Rate

Exchange rates are reported on a daily basis in the financial pages of major newspapers and in numerous Web sites. This is the rate for transactions completed that day and is based on million dollar deposits.

Exchange Rates and Currency Trading

- **Exchange rate**: the price of a currency stated in terms of another currency 4/1/11
  - U.S. dollars per Mexican peso = 0.083918
  - Mexican pesos per U.S. dollar = 11.91636
  - U.S. dollars per Canadian dollar = .971037
  - Canadian dollars per U.S. dollar = 1.029827

Exchange Rates and Currency Trading

- **Appreciation of a currency**: the currency's becoming more valuable (or able to buy more units of another currency)
- **Depreciation of a currency**: the currency's becoming less valuable in relation to another currency

Major Determinants of an Appreciation or Depreciation

- Short Run: Interest Rate Parity

  Anything that changes interest rates or expected interest rates drives currency markets on a daily basis. The impact of other economic data can largely be understood in terms of what it will do to interest rate differentials between nations
- Long Run: Purchasing Power Parity

Economists talk about changes in demand and supply

- The currency you are holding is the one that you supply to foreign exchange markets
- The currency you want or need is the one that you demand
- Demand for currencies is a Derived Demand: It depends on the demand for a nation’s “stuff”

What kinds of “stuff”?

- Goods and Services
- Income: Payments such as dividends and interest
- Gifts/Transfers
- Assets

3 Reasons for Holding Foreign Currency

1. **Trade and investment purposes**
2. **Interest rate arbitrage:** taking advantage of interest rate differentials between countries; arbitrageurs buy money where interest rates are low and sell it where interest rates are high
3. **Speculation:** buying and selling of currency in anticipation of changes in the currency's exchange rate; speculators sell overvalued currencies and buy undervalued currencies

What is the impact of a change in exchange rates on the economy?

- Appreciation—strong, surging, rising, advancing, gaining ground, etc.
- A nation's products cost a foreign partner more. Exports fall, imports rise, foreign investment cheaper
- Depreciation—weak, falling, retreating, declining, losing ground, etc.
- A nation's products are cheaper to foreign buyers. Exports rise, imports fall, potentiallly attract foreign investment in the longer term

Exchange Rate Risk

- Exchange rate risk stems from the fact that currencies are constantly changing in value--$4 trillion in trades per day
  - Expected future payments in a foreign currency will likely be a different domestic currency amount from when the contract was signed
  - Firms that do business in more than one country are thus subject to exchange rate risk

Two Ways to Deal with Exchange Rate Risk

- **<u>Use a Forward Contract</u>: A forward exchange rate is** the price of currency that will be delivered in the future; allows an exporter or importer to sign a currency contract that guarantees a set price for the foreign currency in either 30, 90, or 180 days into the future

- **<u>Buy an Option</u>:** An option is similar to an insurance policy in that it gives the right but not the obligation to make an exchange at a set price at a set date in the future. Exercising the option means making the exchange if it is favorable to do so.

Forward Contracts and Markets

- **Forward exchange rate**: the price of currency that will be delivered in the future; allows an exporter or importer to sign a currency contract that guarantees a set price for the foreign currency in either 30, 90, or 180 days into the future
- **Forward market**: market in which the buying and selling of currencies for future delivery takes place; important mechanism for exporters, importers, financial investors, and speculators

Dealing with Exchange Rate Risk

- **Hedging**: insuring against exchange rate risk through buying a forward contract or an option to lock in an exchange rate that is favorable for the transaction today
  - **With a forward contract, the buyer gives up the possibility of gain from a change in exchange rates to avoid the possibility of loss**
  - **With an option, the buyer pays a premium to avoid loss but still has the chance of gain**

The “Carry” Trade

- Interest rate arbitragers and speculators borrow in one nation to hold balances in a different nation to make a return on the difference in interest rates or expected future changes in exchange rates
- When exchange rates move in a way that hurts this, “unwinding the carry trade” can lead to further appreciation/depreciation as assets are moved.