



CGBP Training

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Trade Finance: Session Two



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Session Introduction

Understanding and Mitigating Exchange Rate Risk

Session Overview



- A recap of financial risk in international trade
- Understanding exchange rate risk
- What an appreciation and depreciation of a currency means and how it potentially affects trade and profits
- How changes in interest rates and changes in inflation affect the exchange rate
- How forward contracts and options reduce risk
- When risks are assumed



Risk

All business has risk, but when trade crosses borders those risks rise and new ones are created.

Sources of risk

- Business risk
- Hazards
- Political risk
- Exchange rate risk





Exchange Rate

The price of one currency in terms of another currency

An Example



- U.S. dollars per Mexican peso = 0.05465 US dollars
- Mexican pesos per U.S. dollar = 18.298 Mex pesos
- Exchange rates are reported on a daily basis in the financial pages of major newspapers and in numerous Web sites. This is the “**spot rate**” or rate for transactions completed that day by institutions such as banks. Retail customers may pay a different amount depending on the country and bank fees.

Spot exchange rate pairs 4/1/26



- USD/CHF .792
- USD/CAD 1.39
- USD/MEX 17.862
- USD/INR 93.422
- USD/JPY 158.53
- USD/COP 3666.37



???

Does this mean we should all head to Colombia for bargains?



In theory, exchange rates should equalize prices

Some goods may be relative bargains or relatively more expensive, but in general it should average out

Reading an exchange rate pair



EUR/USD 1.161 +0.006 +0.502

- The first code stands for euros, the second for US dollars
- The next number is how many units of the second currency in the pair it takes to buy one unit of the first currency in the pair
- The next number is the change in currency units that day. Negative means it takes fewer units of the second to buy the first.
- The final is the change in percentage terms



Exchange rate fluctuations

- **Appreciation of a currency:** A currency is worth more units of another currency
- Verbs the media would use: Strong, rising, advancing, surged, gained ground
- **Depreciation of a currency:** A currency is worth fewer units of another currency
- Verbs the media would use: Weak, falling, declining, lost ground



When a currency appreciates

- That nation's products become more expensive for foreign buyers, depressing exports
- Foreign products become less expensive for domestic buyers, increasing imports
- Net exports (Export-Imports) gets smaller and makes economic growth slow



When a currency depreciates

- That nation's products become less expensive for foreign buyers, increasing exports
- Foreign products become more expensive for domestic buyers, decreasing imports
- Net exports (Export-Imports) gets larger and makes economic growth greater



Most exchange rates are flexible, meaning they change with demand and supply on a minute by minute basis

Some exchange rates are fixed which means the government has to actively intervene to keep its value stable



Even where exchange rates are flexible, governments intervene

The foreign exchange rate market is so large that it is hard for central bank action to move exchange rates for long

Buying means selling and selling buying



- You supply (sell) the currency you have and demand (buy) the currency you need
- If a central bank want to affect the value of its currency, it can buy or sell it using its balances of other currencies
- For example, the Bank of Japan can sell yen and buy other international currencies to weaken the yen



A nation buys its currency when it wants it to appreciate

It sells its currency (buys others) when it wants it to depreciate

Three 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

Four Main Actors in Foreign Exchange Markets



- Retail customers: firms and individuals that hold foreign currency in order to trade, engage in arbitrage, or speculate
- Commercial banks: hold inventories of foreign currencies as part their services to customers
- Foreign exchange brokers: middlemen between buyers (banks) and sellers of foreign currency
- Central banks: a country's bank of banks



Two main theories about exchange rate fluctuations

Purchasing Power Parity: Differences in inflation rates cause changes in exchange rates

Interest Rate Parity: Differences in real interest rates cause changes in exchange rates

Interest Rates and Exchange Rates



- Countries where the real interest rate is perceived to be higher will see their currencies appreciate.
- Countries where the real interest rate is lower will see their currencies depreciate.
- Any news that affects expectations about future interest rate changes affects present exchange rates



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.

Inflation and Exchange Rates



- Nations that have lower rates of inflation than their trading partners will see their exchange rate appreciate.
- Nations that have higher rates of inflation than their trading partners will see their exchange rate depreciate.
- Often does not hold in the short run because changes in inflation expectations influence interest rate expectations and the interest rate expectations tend to dominate

Trade Finance

Task 04-02 After evaluating foreign currency exchange risk, select, implement, and manage risk mitigation techniques to protect the company against fluctuation of foreign exchange.

Exchange rate risk



- Exchange rate risk stems from the fact that currencies are constantly changing in value
 - 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
 - Even firms in the domestic market can face risk if they have foreign competitors or foreign suppliers

Thinking about risk



Being “Long” US dollars

*If you make positive returns if an asset rises in price, you are “LONG”

*If you make negative returns if an asset falls in price, you are “LONG”

A rising U.S. dollar hurts export sales but helps pay for imports

Being “Short” US dollars

If you make negative returns if an asset rises in price, you are “SHORT”

*If you make positive returns if an asset falls in price, you are “SHORT”

A falling U.S. dollar increases export sales but raises costs for imports

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

How a forward contract can reduce risk



- **A forward exchange rate is** the price of currency set today for future delivery. This allows an exporter or importer to lock in an exchange rate for a transaction 30, 90, or 180 days into the future
- **Firms work with their banks on these contracts.** Through their networks, banks have access to deposits denominated in multiple currencies so the forward rate will be based on differences in interest rates paid on various types of deposits.



Forward contracts are best used when the need for the transaction is relatively certain

SMEs like them because they don't have to lay out any money in the present to enter the contract

Option Contracts



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.

Exchange Rate Risk Wrap Up



- Simply buying and selling only in U.S. dollars does not protect you from exchange rate risk
- Changes in interest rates are the primary driver of exchange rate fluctuations
- Forward contracts are the primary hedging tools used by SMEs but option contracts also exist
- Hedging exchange rate risk adds costs

A Word or Two About Cryptocurrencies

What makes money “MONEY”?

The defining function of money

Money is something that is generally accepted in exchange for goods
and services

Other Functions of Money

- Unit of Account
- Store of Value
- Standard of Deferred Payment

Universal Financial Access by 2020

As part of the Sustainable Development Goals, the World Bank is committed to helping 2 billion people obtain a transactions account

<http://www.worldbank.org/en/topic/financialinclusion/brief/achieving-universal-financial-access-by-2020>

International Remittances

- Goal is to reduce the cost of remittances globally from 7 percent to 3 percent of transaction by 2030
- Some financial institutions are using XRP for settlements, and Japanese institutions are expanding into a mobile, domestic settlements use of digital currency
- Reduces prefunding (holding balances prior to transaction) and the time attached for settlement is short so low fluctuation risk

VISION: Digital assets would connect not displace fiat currencies

Lower costs and time required to settle payments, especially in developing world where costs are high and trading volume low

A blockchain based alternative to SWIFT

Not here yet but technological change in payment systems is likely
ongoing









