Global financing and exchange rate mechanisms: hard and soft currencies essay sam...

Economics, Currency

Global Financing and Exchange Rate Mechanisms: Hard and Soft CurrenciesCurrency is an item that is exchanged for goods and services. Currency is in the form of paper bills and coins. These paper bills and coins have monetary value and are considered either hard or soft currency depending on the originating country's government. It's estimated by the Bank for International Settlements that $6. 4 trillion is internationally financed by banks around the world and that the total world banking assets are over $20 trillion (Hill, 2009). Hard and soft currencies are important because every international trade for goods and services requires them. When governments participate in trading they must guard their currency in order to protect their investments and transactions. The following paper will analyze hard and soft currencies and explain how they are used in global financing operations. Lastly, this paper will describe the important for managing risks with hard and soft currencies.

Soft currency is also known as weak currency. Soft currency means that the values of the currency fluctuates frequently and that other countries do not want to possess them due to political or economic insecurity within the country with soft currency (Investopedia, 2009). Most developing countries and low income countries such as Albania, Algeria and Bangladesh are considered countries with soft currency. Current forms of soft currency are the Russian ruble, Mexican peso, Philippines peso, and the Hong Kong dollar. Generally, the governments from these developing and low income countries set unpretentiously high exchange rates, and compare their currency to hard currency such as the United States dollar or British pound.

For example, the Russian ruble is considered a soft currency because Russia is a low income country whose rates are fixed at unrealistic exchange rates which are not back by gold. Since soft currencies countries do not back their currency with gold, countries with hard currency such as the United States and Europe are reluctant to trade assets with them. Countries with soft currency normally have several currency depreciations and have problems with credit repayments due to their government's political instability. Soft currency is the least valuable form of payment compared to hard currency.

Hard currency is known as the strong currency and is the most valuable form of currency in trading internationally. Hard currency is typically from a highly industrialized country and is a form of payment for goods and services that is accepted worldwide. Hard currency relativity remains stable through short periods of time and is highly liquid in the foreign exchange market (Investopedia, 2009). Hard currency comes from countries that have political and economic stability such as Europe, Australia, United States, and Japan. Examples of hard currency are the British pound, the United States dollar, Japanese yen, and the European Euro. Unlike soft currencies, hard currencies are all normally backed with hard money polices.

An example of backing hard currencies with a hard money polices is a country using gold, platinum, and silver to support the value of their currency with an authentic, substantial, material that maintains its value for long periods of time. Backing hard currency with gold, platinum and silver helps keep the currency stable and helps guarantee that it will maintain its value. Hard currencies are typically in higher demand than soft currencies.

Hard currency exchange rates normally appreciate due to their high demand comparative to supply and demand, soft currencies are the opposite.

Gold, silver and copper was commonly used centuries ago in many countries much like hard and soft currencies are used today. Gold, silver and copper were used during the barter system eras, which lead the way in creation of currencies like the pound and dollar. New currencies are not consumer products however; they are considered an institutional right which guarantees that the currency is worth a monetary fund. The currency rate is determined by the central banks and the rate rises and falls based on supply and demand. Two main currency risks are currency inconvertibility and exchange rates.

Currency convertibility means the ease a countries currency can be converted into gold or another currency (Investopedia, 2009). Convertibility is crucial for global commerce and can drastically affect a countries trade. When a countries currency is inconvertible, it’s a risk and a barrier to trade. Countertrade transactions are designed to avoid inconvertible currency and helps ease the risks associated with it. Another risk with currency convertibility is fluctuation in exchange rates meaning a company would receive less money than expected because the currency values decreased. Exchange rates pose a risk because the value of one countries money could be less or more than another country creating problems with trade and compensation.

Countries that are developed have a greater ability in reducing their risks when they are effectively using hard currencies which are backed by hard money policies. Whereas developing countries have an increased difficulty in eliminating their risks because they lack hard currency. A method that developed and developing countries can reduce their risks together is through countertrade. Countertrade is where two countries trade goods with one another rather than goods for currency. Normally both countries are happy with the products they receive. Countertrade is also used by exporters from other countries to gain admission into international markets.

ConclusionDepending if a country is developed or developing, their currency will either be soft or hard. When a country has hard currency it’s backed with hard money policies that make its value reliable and constant. Soft currency on the other hand, can place tension on a newly developing country’s production of products. Ultimately when a soft currency country countertrades with a hard currency country, both countries reduce their risks. The importance of hard and soft currency in reducing risks lies within each individual country’s backing. This paper analyzed hard and soft currencies and explained how they are used in global financing operations. In addition, this paper described the important for managing risks with hard and soft currencies.

References

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