Finance essays example

Economics, Currency

International Finance

Answer 1)

Vehicle Currency refers to a currency which is used to make international transactions between two countries when either of the countries do not have the vehicle currency as their national currency. For Instance, since most of the trade transactions are help in US Dollars, in such case US Dollar can be referred to Vehicle Currency.

Using a vehicle currency, offers following benefits:

Reduced Transaction Cost: A country whose national currency is used as the vehicle currency offers advantages to its resident as they can conduct international trade and commerce with more convenience and lower transaction cost.

Improved Currency Business: With the use of national currency as vehicle currency, domestic financial institution gains business in currency and security exchange. Furthermore, trading partners are willing to improve the business relationship so as to accrue vehicle currency balances to finance further trade.

High Political Power: Apart from the improvement in amount of trade and commerce, politics and prestige is also associated with vehicle currency.

However, status of owning vehicle currency also offer some serious disadvantage as since a large reserve of the national currency is held by the foreign entities as vehicle currency, the currency is vulnerable to greater exchange rate fluctuation. Thus it becomes necessary for the central bank of the owner of vehicle currency to ensure that the currency attains a stable international value.

Answer 2)

Since the British Pound has depreciated in comparison to the US Dollar, it means that British goods are now cheaper for US market. For Instance, during the year 2000, price of one British Pound was $1. 90 which later after 5 years reduced to $1. 45. Thus, while a US buyer was spending $1. 90 to purchase a product from British Market that costed £1, now to purchase the same product he has to spend only $1. 45.

Hence, with British Products turning out to be cheap for US importers, export volume of Britain will rise.

Answer 3)

Since forward exchange rates are an important contributor in forecasting future spot exchange rate, they are of premium importance both for investors and corporate finance managers.

Importance for Investors:

Investors use forward rates to determine the future value of their investments. For instance, an investor purchases a one year Treasury bill or a Six Month treasury bill and after holding the latter for 6 months, again roll it into another 6 month bill. If both the investment styles produces the same return he will be indifferent among each of the bills. The investor will know the spot rate for the six-month bill and the one-year bond, but he or she will not know the value of a six-month bill that is purchased six months from now. Given these two rates though, the forward rate on a six-month bill will be the rate that equalizes the dollar return between the two types of investments mentioned earlier.

For Corporate Finance Managers:

Corporate Finance Managers largely use long term forward exchange rates for the purpose of hedging. Since corporations enter into million of dollar transactions, using forward exchange rate helps in determining the actual payment he needs to pay regardless of the exchange rate prevailing at the time of payment for the transaction.

Answer 4)

In the world of finance, triangular arbitrage is a risk free profit making activity, under which a trader takes the advantage of a mismatch between three currency exchange rates. The process starts by converting the original currency into the second currency and then the second currency is again converted to a third currency. Finally, the third currency is again converted to the original currency so as to exploit the arbitrage opportunity between the currency exchange rates.

Although, Triangular Arbitrage is a risk-free arbitrage opportunity, its is not widely used because such opportunities rarely arises and even when they does, they remain for few seconds only. Hence, it is possible only for sophisticated and high frequency traders who are equipped with latest technology to exploit such arbitrage opportunities.

Works Cited

Schaefer, Howard G. " International Economic Trend Analysis." Schaefer, Howard G. International Monetary System. USA, 2010. 136-137.