Free essay on foreign exchange

Business, Marketing

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Introduction

The currency of a nation is used as a medium of exchange and reference in all domestic financial transactions of a country. With globalisation and integration of economies, international business has become a common phenomenon. International business requires buying, selling and exchange of money between two nations. Since, economies across the world have their own currencies and value of each of these currencies vary at any given point in time, relative value of one currency with respect to another becomes an important aspect during international financial transactions. This has concerted international focus on the concept of foreign exchange, which deals with the relative values of any two given currencies. The paper attempts to understand the foreign exchange markets, the process of

determination of exchange rates, types of exchange rates and the related risks.

The paper is broadly divided into five sections. The first section discusses the foreign exchange markets. The second section talks about the balance of payments and the determination of exchange rates. The third section describes the fixed and flexible exchange rates. The fourth section highlights the risk associated with foreign exchange and briefly discusses the concept of forward contracts. The fifth section concludes the paper.

Markets for Foreign Exchange

The foreign exchange market is global, and it is conducted over-the-counter (OTC) through the use of electronic trading platforms, or by telephone through trading desks (PFG Best, n. d.). The market for foreign exchange involves buying and selling of currencies of different economies. Given the increased economic integration and focus on international business, market for foreign exchange has become very active and large. In fact, foreign exchange is the largest market in the world, with volume that exceeds commodities, financial futures and stocks by far (PFG Best, n. d.). But the actual trade volume of foreign exchange market is hard to estimate as many different foreign exchange markets operate worldwide. Not only is this market the largest, but is it also growing at a very fast pace. According to Ickes (2006), the estimated turnover (in traditional products) in 1998 in the United States was estimated to be $351 billion per day, which is a 43% increase over 1995 and about 60 times the turnover in 1977. This growth and volume is not limited to one nation alone. The global estimates are as

large as the figures for the United States. The trade volume of foreign exchange market is much larger than the value of global trade and global gross national product. The annual volume of foreign exchange trading is some 60 times larger than annual world trade and even 10-12 times larger than world GNP based on 1995 figures (Ickes, 2006).

Foreign exchange is commonly known as forex. Trading forex is buying one currency while at the same time selling a different currency (PFG Best, n. d.). Along with the spot or OTC trading market of forex, a forward market for forex also exists. The forward market, including futures and options, are mainly responsible for adding volume to the forex market. The exchange rate of a currency in the futures market reflects the sentiments of people towards a particular currency.

There are five important functions of forex. First, it is used a base or reference for international transactions. International transfers require forex market to convert the money from one currency to another. Since international business transactions are carried out in two nations with two different currencies that are volatile and change frequently, it becomes imperative to base a contract on some forex rate. Second, it helps in reporting earnings from international business in domestic currency. Third, trading in forex markets can be done with a view to earning profits due to appreciation or depreciation of a particular currency. Fourth, trading is forex market helps mitigate risks associated with appreciation or depreciation of currencies. Fifth, forex markets are required for extending international credit.

Balance of Payments and Determination of Exchange Rates

A Balance of Payments is an accounting statement that enlists all international financial transactions carried out between a nation and all other nations, during a given period of time. The balance of payments statement is usually composed of a current account and a capital account (Sharma, 2011). The entries pertaining to import-export of goods and services are recorded in the current account. It comprises of three types of items or transfers. Transfer of goods form the visible trade, transfer of services form the invisible trade and transfer of an economic good or service without expectation of anything in return form an example of unilateral trade. The transfer of capital goods between two nations is recorded in the capital account. Now, these current account and capital account transfers determine the exchange rate of a particular currency with respect to another currency.

The balance of payments theory of exchange rate holds that the price of foreign money in terms of domestic money is determined by the free forces of demand and supply on the forex market (Nirav, 2012). Demand for forex arises when:

A visible or an invisible good is bought from another country

A unilateral trade is performed, for example, a gift is sent to another country

A capital good is purchased from another country

The supply of forex takes place when:

A visible or an invisible good is sold to another country

A unilateral trade flows from another country, like when a gift is received

A capital good is sold to another country

In addition to these factors that affect demand and supply of forex, speculators play a significant role in determining the forex rate. They provide significant volume to the forex market. The demand and supply of forex are opposite forces. Going by the theory that the price of a currency is inversely proportional to its demand, the forex demand curve is downward sloping. Likewise, if a currency devalues or depreciates, its supply also shrinks as the incentive to supply has reduced. Hence, forex supply curve is upward sloping. Forex rate and quantity is determined at the point of equilibrium where the forex demand and supply curve intersects. The forex rate has a tendency to remain at the equilibrium forex rate in the long run.

According to the Balance of Payment theory, a deficit in the balance of payments leads to fall or depreciation in the rate of exchange (Nirav, 2012). Likewise, a surplus in the balance of payments account means that the demand for home currency is more than that have foreign currency, and the home currency appreciates with respect to the foreign currency. A parallel shift in the demand or supply curve can change the equilibrium forex rate.

Fixed and Flexible Exchange Rates

Broadly, there are two types of exchange rate: the Fixed Forex Rate and the Flexible Forex Rate.

Fixed Exchange Rate

A fixed exchange rate is where the government determines the exchange rate for a period of time based on the value of another country's currency such as the US dollar (Edge, 1999). The onus of fixing the exchange rate lies on the government and the government can also take the help of other

agencies to fix the exchange rate. The value of exchange rate is usually fixed against the value of gold. There are two major benefits of using a fixed exchange rate system. First, in a fixed exchange rate system, changes in the forex demand and supply forces due to economic volatility do not affect the exchange rate. Since the global economic scenario is uncertain, an independent system of determining exchange rate helps bring stability. Second, fixed exchange rate system allows government to have a control over the exchange rate and government can make necessary adjustments based on its underlying economic policies.

The main advantage of this system is that it reduces volatility and fluctuations in the exchange rate. The key drawback is that it is vulnerable to human intervention and manipulation.

Flexible Exchange Rate

A flexible or floating exchange rate is where the market forces of supply and demand determine the exchange rate (Edge, 1999). The flexible exchange rate system is in line with the principles of free market economy, where market forces determine the exchange rate. The government does not fix the exchange rate; hence it is less susceptible to human manipulation. When there is practically no intervention of the government in the free market operations, a ‘ clean float’ is said to exist (Edge, 1999). The balance of payments and demand and supply forces determine the flexible exchange rate.

There are five key benefits of a flexible exchange rate. First, it does away with government intervention, and is less vulnerable to human mishandling.

Second, by providing a favourable investment horizon, it facilitates international trade. Thus, it boosts the economic growth of a country. Third, it makes the economy more efficient by depending upon the free market principles. Fourth, international investment is facilitated in the system of flexible exchange rate. Fifth, flexible forex provides independence and autonomy to a nation to implement an independent monetary policy.

There are a few flipsides of flexible exchange rate too. It increases the volatility of exchange rate. The increased volatility makes the exchange rate unstable and unsuitable for trade negotiations. Long term international investments are also impacted due to the risk of changing value of exchange rate.

Foreign Exchange Risk and Exposure

While dealing in foreign currencies, it is usual that the currency appreciates or depreciates in the process affecting the foreign exchange rate. This is also true because the exchange rate for most currencies is determined through the flexible exchange rate system. This volatility in the exchange rate carries significant risk for investors who are involved in trading in the foreign currency. Thus, a business proposition or a capital investment that might appear to be profitable now may be rendered unprofitable in future due to movements of forex rates. This risk is commonly known as exchange rate risk or foreign exchange risk. Investors need to take the foreign exchange risk into account when involved in businesses that involve foreign currency exposure. The foreign exchange risk can be contained either through hedging or netting off the trade.

Hedging is a commonly used technique to minimising foreign exchange rate risk. It refers to the process of buying or selling of foreign currency in forward markets. An exporter of agricultural equipment is exposed to foreign exchange risk as payments in foreign currency are expected at a future date. Thus, the exporter is exposed to risk of foreign exchange rate. The exporter will have foreign exchange gains (or losses) if the foreign currency strengthens (or weakens) as compared to the home currency. To minimise this risk, an exporter can get into forward contract. Since the exporter is expecting money in foreign currency, she can get into a forward contract of selling the foreign currency. If the foreign currency appreciates, the exporters gain from receiving foreign currency will be offset by the loss incurred in the forward contract. Similarly, if the foreign currency weakens with respect to the home currency, the exports loss from receiving export payments will be compensated by gains from the forward contract. Interest rate swaps are commonly used as contract to avoid the foreign exchange rate risk.

The main benefit of forward foreign exchange contract is that it hedges against the risk of fluctuation in the foreign exchange rate. There are two main disadvantages of forward contracts. First, it is difficult to gain from the movements of exchange rate as the future exchange rate is pre-fixed. It is like an insurance policy that is a risk mitigation tool, and one cannot use it to book profits. Second, the contract is binding and need to be executed even during unfavourable movement of forex rate.

Netting of is another means of minimising foreign exchange risk. Netting is a process by which investors and traders maintain zero exposure to foreign currency, thereby doing away with the risk of foreign currency exposure. This is done by maintaining the foreign exchange receivables and payables at the same level. Since the net payable or receivable is zero at any given point of time, there is no impact of movements in foreign exchange rate on the profitability of a business. The benefit of netting is that it reduces the transaction costs of foreign currency conversion by reducing the total cash volume.

Conclusion

With globalization and integration of world economy, international fund flow has become a common phenomenon. The flow of funds can be in the form of trade related transfer, unilateral transfers and capital investment related transfers. In any form of money transfer, foreign exchange plays an important role. This is because currency of any two nations is different and their relative value also keeps fluctuating. The equilibrium exchange rate is determined at the point of intersection of the demand and supply forces of foreign exchange. Speculators play a significant role in this phenomenon by affecting the demand and supply curves. A major part of the volume of foreign exchange market is contributed by the speculators.

Flexible foreign exchange system is commonly used for determining the exchange rate. This adds to the volatility of exchange rates. Thus, risk management techniques are required to be used to avoid foreign exchange

exposure risks. Hedging and netting are two important tools to minimize the risk of foreign currency exchange rate movements.

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