

# Case study on evaluation of the foreign currency management strategy

[Business](#), [Marketing](#)



\n[[toc title="Table of Contents"](#)]\n

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1. [Question one](#) \n \t
2. [Question Two](#) \n \t
3. [Advantages of Pasminco using foreign exchange forward contract](#) \n \t
4. [Disadvantages of Pasminco using interest swaps](#) \n \t
5. [Question Three](#) \n \t
6. [Works Cited](#) \n

\n[/toc]\n \n

## **Question one**

The major type of risk that Pasminco faces are:

- Interest rate risk- this risk is due to financial market conditions. Pasminco borrowings may be based on a fixed on floating rate of interest. It is obvious Pasminco has debt financing in its portfolio and if they are charged variable interest rates on their loans then there is a risk that the level of interest charged may be unfavorable if market interest rates are high. Pasminco most probably failed to raise intermediate financing because their credit rating had fallen to warrant the difficulty in raising additional capital from lenders. In addition, interest rate movements can impact indirectly Pasminco's present and future cash flows. For example, an increase in interest rate could adversely affect the Pasminco if her consumers are reluctant to make purchases in high interest rate environment because at such time they may be having low disposable income or if they do purchase they might just do it on credit basis.

- Foreign exchange risk- this risk is closely related to the interest rate risk. Exchange rates are to a large extent affected by countries interest rates. Australian base rates (set by its central bank) will determine the economic and inflationary condition of commodities. In the case where the inflation rate is rising then there is a most likely event that the Australian dollar will depreciate against the US dollar. In the same way should the inflation rates in the United States go up or increase then the Australian dollar will appreciate. This in turn affects the subsidiary value in profits remittance back to Australia.
- Risk caused by economic policy in country of operation - In the case where the economic policies of the two countries differs or are not favorable for multinational operations then there is a high risk of costly establishments. An example is, the US and Australia tax policies should be setup to eliminate double taxation of subsidiaries of Pasiminco pretax profits. The subsidiaries have to abide to both countries' regulation rules and this usually comes at a cost.
- Political risk- In the context of Pasiminco, the political conditions in the countries mentioned are quite favorable. Both the countries (Australia and the United States) are politically stable. It is seen that most of the leaders involved in politics are also involved in economic policies formulation of a country. This in turn directly affects the economic conditions of the two countries. Almost always, the election of certain leaders usually has a direct bearing on the financial market performance to express confidence in economic ideologies in the government or not.
- Credit risk- this is the risk that Pasiminco might default in repaying its

loans. International borrowing in the form of corporate bonds or Eurobonds are almost always affected by market interest rates. This is because these securities are not secured (unsecured), i. e. no collateral is required for the borrowing of the bonds. This risk can affect Pasminco's credit rating if a large portion of their assets are purely backed by their debt finances.

There are two risks that are mostly pervasive to Pasiminco multinational operation, and they are the interest rate risk and the foreign exchange risk. Cash transfer from the Parent company in Australia to the Subsidiaries in the United States and Wales involves foreign exchange risk. When the financial markets are in operation during the day, the exchange rate can change from favorable to unfavorable in short time frame. This leads to a marginal loss in cash transfers of different countries.

## **Question Two**

There are a number of hedging strategies that Pascimo can employ to minimize the risks associated with multinational transactions.

The first hedging strategy used was interest rate swaps, its advantages in perspective of Pasminco operations are:

Advantages of Pasminco using interest swaps

- Interest rate swaps involves exchanging a series of payments (two way payment exchange). One on fixed term and the other on variable terms, that is, on short term interest rate levels. If the interest rates are favorable- that is the floating rate charged on debt financing is below the market rate- then Pasminco will pay less interest on their loans and invest the marginal difference between the floating rate and the market rate to get a return.

- The interest swap reduces exposure in change in short term interest rates which is a major factor that affect foreign exchange risk directly. Pasminco can use it to obtain cheaper financing and enhance returns.

### **Advantages of Pasminco using foreign exchange forward contract**

- If Pasminco enters a currency forward contract she ends up buying the US dollar at a lower value if the market price of the US dollar is higher than the strike price of the forward contract. On the other hand if they buy the forward contract and its market price (that of the US dollar) fall below the strike price then Pasiminco will have to pay more than they needed.

### **Disadvantages of Pasminco using interest swaps**

- The only disadvantage is that Pasiminco may not take advantage of arbitrage opportunities that arise with foreign exchange and in any case the floating rate adversely affects the exchange in interest payments between the counter parties.

Other hedging strategies that Pasminco can use are an interest rate future and an interest rate option. The interest future can be used to protect against rise in interest rate by use of means of short hedge. In the case where interest rates go up, the price of futures contract fall and Pasminco can purchase it at the low price in the process making a profit on the futures deal. The profit will compensate for actual rise in interest rates experienced by borrowed funds from lenders like banks and other lending institutions. If interest rates move in the opposite direction from what is expected future loss will occur but this will, to some extent, offset by gains from cheaper

interest costs in the cash market. Although it is prudent to be aware that hundred percent hedging is not possible.

Interest options such as caps, collars and floors guarantee that the interest will not fall and alternatively rise above an agreed fixed level during a specific period. If Pasminco buys an interest option it has the opportunity to take full advantage of favorable interest rate condition and also protecting itself against downside risk that the interest rate will rise. Pasminco will have to pay a premium on the interest rate option. This premium is usually expensive for most companies but can guarantee hedging of downside risk.

### **Question Three**

Some of the operating factors Pasminco could have considered correcting their consistent investment strategy that seemed not to work. Pure hedging doesn't really give a return but only greatly minimize the downside risk.

Partial hedging gives some room for great return on investment and arbitrage opportunity to arise. Pasminco deals with mining and so commodity pricing is an important factor that will affect their ability to make profits. Pasminco greatly focused on hedging their risks rather than directly pushing for sales of commodities they produce in order to pay back all their international debts.

The financial managers would have possibly invested borrowed funds in equities and bonds and other forms of fixed income securities. Essentially having a balanced investment portfolio with suitably correlated investment vehicles would have minimized the risk with guarantee of investment return. Derivatives such as future, swaps and options might help transfer risk to a

third party but how will profit be achieved if the risk is not held within the company's investment portfolio. Pasminco invested using all the derivatives which means to an extent there was no clear direction in minimizing its risk. Probably using two derivatives would have helped.

Rio Tinto uses arbitrage opportunities in percentage point difference between the two currencies (US dollar and the Australian dollar) at any given time the foreign exchange market operation are underway. Eventually the market corrects itself after an arbitrage opportunity is exercised. Pasminco can also defer.

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