Global financing and exchange rate assignment

Business

Global Financing and Exchange Rate Mechanisms March 07, 2009 Global Financing and Exchange Rate Mechanisms Hard currencies are a currency, usually from a highly industrialized country, that is widely accepted around the world as a form of payment for goods and services. A hard currency is expected to remain relatively stable through a short period of time, and to be highly liquid in the forex market (Investopedia, 2009). The forex market is the largest, most liquid market in the world with an average traded value that exceeds $1. 9 trillion per day and includes all of the currencies in the world.

There is no central marketplace for currency exchange; trade is conducted over the counter. The forex market is open 24 hours a day, five days a week, and currencies are traded worldwide among the major financial centers of London, New York, Tokyo, Zurich, Frankfurt, Hong Kong, Singapore, Paris and Sydney (Investopedia, 2009). Another criterion for a hard currency is that the currency must come from a politically and economically stable country. The U. S. dollar and the British pound are good examples of hard currencies (Investopedia, 2009). Soft currency is another name for “ weak currency”.

The values of soft currencies fluctuate often, and other countries do not want to hold these currencies due to political or economic uncertainty within the country with the soft currency. Currencies from most developing countries are considered to be soft currencies. Often, governments from these developing countries will set unrealistically high exchange rates, pegging their currency to a currency such as the U. S. dollar (Investopedia, 2009). Hard Currency is used in global financing operations by developed nations. Hard currency is easily traded and bartered throughout the world.

Using hard currency ensures that there is an even playing field for all parties in the transaction. Hard currency is important in managing risks because “ a company can counter an imminent devaluation by speeding up collections of receivables, postponing bill paying, and converting cash into hard currency” (Feist, Helly, & Lu, 1999) . Another way that hard currency manages risks is by utilizing or adopting it, it is least likely to be a factor in the loss of funds. World organizations which invest internationally face the prospect of uncertainty in the returns after they convert the foreign gains back to their own currency.

Unlike the past when most U. S. investors ignored international investing alternatives, investors today must recognize and understand exchange rate risk, which can be defined as the variability in returns on securities caused by currency fluctuations. Exchange rate risk is sometimes called currency risk. This risk is true for the nations also. For example if a currency is free-floating, its exchange rate is allowed to vary against that of other currencies. Exchange rates for such currencies are likely to change almost constantly as quoted on financial markets, mainly by banks, around the world.

This can lead to lot of speculation and also losses especially for weak economies. Moreover investors generally prefer hard currencies to soft currencies at times of increased inflation (or more precisely increased inflation differentials between countries), at times of heightened political or military risk, or when they feel that one or more government-imposed exchange rates are unrealistic. In some cases, an economy may choose to abandon local currency altogether and adopt a hard currency as legal tender.

Examples include the adoption in Ecuador and Panama of the US dollar, and the adoption in Kosovo and Montenegro of first the German mark and later the euro. “ Countries open to capital flows can adopt a wide range of arrangements, from free floating to a variety of crawling pegs with broad bands around them (under which the central exchange rate is frequently and marginally adjusted), as well as very hard pegs sustained by policy commitments such as currency boards, dollarization (or, more generally, the adoption of another foreign currency as legal tender), or membership in a currency union” (Finance & Development, 2001).

Hard pegs are defined as “ In economics, a policy in which the authorities insist on some permanent, precise guarantee of the value of the local currency to some other thing: a unit measure of gold, the US dollar, the euro, or the pound. Historically, the US dollar had a hard peg to gold from 1946 to 1971, while other currencies in the developed world had a hard peg to the US dollar. Since 1971, most of the world’s money is in floating currency (whose relative value is set by the free market)” (Urban Dictionary).

A floating currency is “ A currency whose value is set by the currency markets; money whose exchange rate relative to other currencies is determined mainly or entirely by unrestricted trading in the currency. Most currencies are dirty float | dirty floats, which means that the government issuing them attempts to manage their traded value in some way; or else hard peg | hard pegs, in which the value is tied to something specific. When a currency is floating, then its value may rise because the county is running a trade surplus, or it is running a capital account surplus.

Floating currencies are not fiat money, although they are often confused for each other" (Urban Dictionary). In some cases the US dollar is considered fiat money because it is deemed " money that (a) derives its value entirely from the mandate of the government, and (b) cannot be freely traded. Fiat money is not the same thing as floating currency, because if a floating currency is intrinsically worthless then its lack of worth will be reflected in the forex markets.

Fiat money, on the other hand, does not require a disciplined monetary of fiscal policy on the part of the issuing authorities; exchange rates are fixed by decree, which means the state also controls supplies of hard (foreign) currency" (Urban Dictionary). " Times change, and a currency that is considered weak at one time may become stronger, and perceived as a hard currency later on. For example, the pound sterling was considered structurally weak and liable to depreciate (in real terms) for much of the post World War II period; now it is considered to have re-established fiscal and monetary soundness and to be strong.

The U. S. dollar (USD) has been considered a strong currency in recent years, and importantly a safe-haven in times of international tension or war, but the USA has large fiscal and trade deficits and an unresolved problem that many Asian currencies are pegged to the dollar and therefore do not appreciate as their trade surpluses with the USA grow; some commentators believe that these considerations imply that the U. S. dollar will now enter a period of weakness, especially that there are signs that China may be relaxing the rate at which the yuan is pegged to the dollar" (Answers, 2007).

Soft Currency is used in global operations by underdeveloped or unstable nations. Soft currency is also used as local currency like the Mexican peso. Soft currency is important in managing risks because it is a warning for companies to take proactive measures to reduce currency exchange losses. Soft pegs may lead speculation, which can be costly in industrialized countries, but are frequently harmful to emerging market countries, as in Latin America (Mexico and Ecuador), East Asia (Thailand, Korea, and Indonesia) and Turkey.

The breakdown of soft pegs in emerging market countries is as damaging as it is because their debt structure is generally short term and is denominated in foreign currency. Thus a successful speculative attack leads to a sharp deterioration in balance sheets, which in turn leads to a financial crisis. Hard pegs may be desirable, particularly in countries whose political and monetary institutions are especially weak; they can used to stabilize the economy. However, hard pegs will not be successful in promoting a healthy economy unless government policies create the right institutional environment.

Thus Pegging has typically been a way to substantiate the value of a local currency against the world’s convertible currencies and to stabilize the exchange rate. References Investopedia, (http://www. investopedia. com/terms/s/softcurrency. asp) Feist, William R. , Heely, James A. , & Lu, Min H. (1999). Managing A Global Enterprise. , Greenwood Publishing Group. International Financial Management by Madhu vij Finance & Development, (http://www. imf. org/external/pubs/ft/fandd/2001/06/fischer. htm) Urban

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