Chapter 20 - Currency Risk

Introduction

Currency risk is a type of risk in international trade that arises from the fluctuation in price of one currency against another. This is a permanent risk that will remain as long as currencies remain the medium of exchange for commercial transactions. Market fluctuations of relative currency values will continue to attract the attention of the exporter, the manufacturer, the investor, the banker, the speculator, and the policy maker alike.

While doing business in foreign currency, a contract is signed and the company quotes a price for the goods using a reasonable exchange rate. However, economic events may upset even the best laid plans. Therefore, the company would ideally wish to have a strategy for dealing with exchange rate risk.

Currency Hedging

Currency hedging is technique used to avoid the risks associated with the changing value of currency while doing transactions in international trade. It is possible to take steps to hedge foreign currency risk. This may be done through one of the following options:

- Billing foreign deals in Indian Rupees: This insulates the Indian exporter from currency fluctuations. However, this may not be acceptable to the foreign buyer. Most of international trade transactions take place in one of the major foreign currencies USD, Euro, Pounds Sterling, and Yen.
- Forward contract. You agree to sell a fixed amount of foreign exchange (to convert this into your currency) at a future date, allowing for the risk that the buyerâ€™s payments are late.
- Options: You buy the right to have currency at an agreed rate within an agreed period. For example, if you expect to receive $35,000 in 3 months, time you could buy an option to convert $35,000 into your currency in 3 months. Options can be more expensive than a forward contract, but you don't need to compulsorily use your option.
- Foreign currency bank account and foreign currency borrowing: These may be suitable where you have cost in the foreign currency or in a currency whose exchange rate is related to that currency.

FOREX Market

Forex market is one of the largest financial markets in the world, where buyers and sellers conduct foreign exchange transactions. Its important in the international trade can be estimated with the fact that average daily trade in the global forex markets is over US $ 3 trillion. We shall touch upon some important topics that affect the risk profile of an International transaction.

Spot Rate

Also known as "benchmark rates", "straightforward rates"or "outright rates", spot rates is an agreement to buy or sell currency at the current exchange rate. The globally accepted settlementcycle for foreignexchange contracts is two days. Foreignexchange contracts are therefore settled on the second day after the day the deal is made.

Forward Price

Forward price is a fixed price at which a particular amount of a commodity, currency or security is to be delivered on a fixed date in the future, possibly as for as a year ahead. Traders agree to buy and sell currencies for settlement at least three days later, at predetermined exchange rates. This type of transaction often is used by business to reduce their exchange rate risk.

Forward Price vs. Spot Price

Theoretically it is possible for a forward price of a currency to equal its spot price However, interest rates must be considered . The interest rate can be earned by holding different currencies usually varies, therefore forward price can be higher or lower than (at premium or discount to) the spot prices.

RBI Reference Rate

There reference rate given by RBI is based on 12 noon rates of a few selected banks in Mumbai.

Inter Bank Rates

Interbank rates rates quotes the bank for buying and selling foreign currency in the inter bank market, which works on wafer thin margins . For inter bank transactions the quotation is up to four decimals with the last two digits in multiples of 25.

Telegraphic Transfer

Telegraphic transfer or in short TT is a quick method of transfer money from one bank to another bank. TT method of money transfer has been introduced to solve the delay problems caused by cheques or demand drafts. In this method, money does not move physically and order to pay is wired to an institutionsâ€™ casher to make payment to a company or individual. A cipher code is appended to the text of the message to ensure its integrity and authenticity during transit. The same principle applies with Western Union and Money Gram.

Currency Rate

The Currency rate is the rate at which the authorized dealer buys and sells the currency notes to its customers. It depends on the TC rate and is more than the TC rate for the person who is buying them.

Cross Rate

In inter bank transactions all currencies are normally traded against the US dollar, which becomes a frame of reference. So if one is buying with rupees a currency X which is not normally traded, one can arrive at a rupeeexchange rate by relating the rupee $ rate to the $X rate . This is known as a cross rate.

Long and Short

When you go long on a currency, its means you bought it and are holding it in the expectation that it will appreciate in value. By contrast, going short means you reselling currency in the expectation that what you are selling will depreciate in value.

Bid and Ask

Bids are the highest price that the seller is offering for the particular currency. On the other hand, ask is the lowest price acceptable to the buyer.Together, the two prices constitute a quotation and the difference between the price offered by a dealer willing to sell something and the price he is willing to pay to buy it back.

The bidask spread is amount by which the ask price exceeds the bid. This is essentially the difference in price between the highest price thata buyer is willing to pay for an asset and the lowest price for whicha seller is willing to sell it.

For example, if the bid price is $20 and the ask price is $21 then the "bidask spread" is $1.

The spread is usually rates as percentage cost of transacting in the forex market, which is computed as follow :

Percent spread =(Ask priceBid price)/Ask price *100

The main advantage of bid and ask methods is that conditions are laid out in advance and transactions can proceed with no further permission or authorization from any participants. When any bid and ask pair are compatible, a transaction occurs, in most cases automatically.

Buying and Selling

In terms of foreign exchange, buying means purchasing a certain amount of the foreign currency at the bid or buying price against the delivery /crediting of a second currency which is also called counter currency.

On the other hand, selling refers to a fix amount of foreign currency at the offered or selling price against the receipt / debiting of another currency.

FOREX Rates vs. Interest Rates

Forex rates or exchange rate is the price of a country's currency in terms of another country's currency. It specifies how much one currency is worth in terms of the other. For example a forex rate of 123 Japanese yen (JPY, Â¥) to the United States dollar (USD, $) means that JPY 123 is worth the same as USD 1.

Choice of currency and its interest rate is a major concern in the international trade. Investors are easily attracted by the higher interest rates which in turns also effects the economy of a nation and its currency value.

For an example, if interest rate on INR were substantially higher than the interest rate on USD, more USD would be converted into INR and pumped into the Indian economic system. This would result in appreciation of the INR, resulting in lower conversion rates of USD against INR, at the time of reconversion into USD.

Calculating the Forward Rates

A forward rate is calculated by calculating the interest rate difference between the two currencies involved in the transactions. For example, if a client is buying a 30 days US dollar then, the difference between the spot rate and the forward rate will be calculated as follow:

The US dollars are purchased on the spot market at an appropriate rate, what causes the forward contract rate to be higher or lower is the difference in the interest rates between India and the United States.

The interest rate earned on US dollars is less than the interest rate earned on Indian Rupee (INR). Therefore, when the forward rates are calculated the cost of this interest rate differential is added to the transaction through increasing the rate.

USD 100,000 X 1.5200 = INR 152,000
INR 152,000 X 1% divided by 12 months = INR 126.67
INR 152,000 + INR 126.67 = INR 152,126.67
INR 152,126.67/USD 100,000 = 1.5213