

SITPRO

International Trade Guides

Financial

The Foreign Exchange Market

The Foreign Exchange Market

This guide explains the risks involved with sales and purchases made in a foreign currency, and the actions you can take to reduce the risks and help you to remain competitive internationally.

You should read it if you trade in a foreign currency, have assets overseas or have a need to manage your foreign exchange exposure. You may wish to pass on the information in this Briefing to your colleagues in the Sales & Marketing team and the Purchasing Department, and your Finance Director so that they are aware of these issues.

Introduction

The Foreign Exchange Market is vast in size and scope and exists to fulfil a number of purposes ranging from the finance of cross-border investment, loans, trade in goods and services and of course, currency speculation. Trading may be for "spot" or "forward" delivery. A spot contract is a binding obligation to buy or sell a certain amount of foreign currency at the current market rate. A forward contract is a binding obligation to buy or sell a certain amount of foreign currency at a pre-agreed rate of exchange, on or before a certain date.

The Spot and Forward Markets

A participant in the Foreign Exchange Market will normally ask for a price in, for example, 'sterling-dollar' (also known as 'Cable'), the number of US Dollars, which can be bought for one British pound. They will be quoted two prices - these are called a bid price and an offer price. If the rate of exchange is £1 = \$1.6362-75 this will be quoted as 1.6362-75, or "sixty two - seventy five", i.e. they buy dollars at 1.6362 and sell dollars at 1.6375.

Spot Dealing

Spot dealing has the advantage of being the simplest way to meet all your foreign currency requirements, but it also carries with it the greatest risk of exchange rate fluctuations, as there is no certainty of the rate until the transaction is carried out. The spot rate you receive will be set by current market conditions, the supply and demand for the currencies being traded and the amount you are dealing. Generally speaking, the larger the amount being dealt, the better the spot rate you will receive.

A spot deal will settle (in other words the physical exchange of currencies takes place) two working days after the deal is struck.

The Forward Market

The Forward Market requires a more complicated calculation - a forward rate is based on the prevailing spot rate plus (or minus) a premium (or discount) which are determined by the interest rate differential between the two currencies involved. For example, UK interest rates are higher than those in the U.S. and so an adjustment is made to the spot rate to reflect the monetary effect of this differential over the period of the forward contract. The important thing to remember is that a forward rate is not a guess as to what the spot rate is going to be in the future; it is purely a mathematically driven calculation.

A forward rate will protect you against unfavourable movements, but will not allow gains to be made should the exchange rate move in your favour in the period between entering the contract and final settlement of the currency.

Forward contracts are available for any period up to two years - longer periods are available in certain currencies.

Companies Trading Only in the UK

Any company can be affected by fluctuations in the foreign exchange markets whether they are directly involved in international trade or not. If you trade only in the UK, depreciation in the value of sterling against the euro, for example, will affect your relative competitiveness and you may find an influx of competition from the eurozone countries which could in turn lead to a loss of market share for you. This problem is often referred to as being 'Economic' foreign exchange exposure and is perhaps the most difficult form of exposure to protect your business from.

Importers, Exporters and Exchange Rates

If you are an Importer or Exporter, on the other hand, you will find yourself exposed to easily identifiable form of foreign exchange risk known as 'Transactional' exposure. This arises from your need to either buy or sell currency relating to a trade transaction in return for sterling. Movements in exchange rates can work in your favour and enhance profitability but, equally, they can have the opposite effect and seriously erode profit margins or lead to making a loss.

Owning Assets Abroad

If you own an overseas subsidiary, asset of liability but are a UK company, you will need to think about how to record it on your balance sheet in pounds sterling as fluctuations in exchange rates will affect the value. This type of foreign exchange exposure is known as 'translation' exposure.

Trading Overseas in Sterling

Foreign exchange risk may apply even if both your costs and income are in sterling. If for example, you have overseas customers who pay you in Sterling, a strengthening in Sterling may make your products too expensive and affect your competitiveness. In essence, by using Sterling abroad you are merely passing the foreign exchange risk to your trading partners who may in turn, find someone else to deal with who are prepared to deal in their own currency.

Emerging Markets

Certain markets, particularly in Latin America, Eastern Europe and Asia, still have developing economies compared with Western countries which often means that they will have restrictions in the form of legal and regulatory frameworks designed to protect their currencies and economies from speculators. This makes trading in these currencies much more difficult than with the major world currencies and you may need to consider dealing in those countries in a 'hard currency' such as the U.S. dollar instead.

Managing Your Foreign Exchange Risk

Once you have a clear idea of what your foreign exchange exposure will be and the currencies involved, you will be in a position to consider how best to manage the risk. The options available to you fall into three categories:

- **Do Nothing:** You might choose not to actively manage your risk, which means dealing in the spot market whenever the cash flow requirement arises. This is a very high-risk and speculative strategy, as you will never know the rate at which you will deal until the day and time the transaction takes place. Foreign exchange rates are notoriously volatile and movements make the difference between making a profit or a loss. It is impossible to properly budget and plan your business if you are relying on buying or selling your currency in the spot market.
- **Take out a Forward Foreign Exchange Contract:** As soon as you know that a foreign exchange risk will occur, you could decide to book a forward foreign exchange contract with your bank. This will enable you to fix the exchange rate immediately to give you the certainty of knowing exactly how much that foreign currency will cost or how much you will receive at the time of settlement whenever this is due to occur. As a result, you can budget with complete confidence. However, you will not be able to benefit if the exchange rate then moves in your favour as you will have entered into a binding contract which you are obliged to fulfil. You will also need to agree a credit facility with your bank for you to enter into this kind of transaction.

- **Use Currency Options:** A currency option will protect you against adverse exchange rate movements in the same way as a forward contract does, but it will also allow the potential for gains should the market move in your favour. For this reason, a currency option is often described as a forward contract that you can rip up and walk away from if you don't need it. Many banks offer currency options which will give you protection and flexibility, but this type of product will always involve a premium of some sort. The premium involved might be a cash amount or it could be factored into the pricing of the transaction.

Finally, you may consider opening a Foreign Currency Account if you regularly trade in a particular currency and have both revenues and expenses in that currency as this will negate to need to exchange the currency in the first place.

The method you decide to use to protect your business from foreign exchange risk will depend on what is right for you but you will probably decide to use a combination of all three methods to give you maximum protection and flexibility.



Acknowledgement

SITPRO gratefully acknowledges the assistance of HSBC in the drafting of this guide.



SITPRO

Simplifying International Trade

7th Floor
Kingsgate House
66-74 Victoria Street
London
SW1E 6SW

Telephone: +44 (0)20 7215 8150

Fax: +44 (0)20 7215 4242

Email: info@sitpro.org.uk

Website: www.sitpro.org.uk

SITPRO Ltd. is a company limited by guarantee
Registered in England & Wales No. 4188890

© Copyright SITPRO Ltd. 2007
This guide may not be republished, in full or in
part, without SITPRO's prior permission