

# International Trade and the Foreign Exchange Markets

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This information will be useful if you buy or sell products in a foreign currency, have assets or plan to have assets overseas and also for those who have a need to manage their exposure within foreign currency.

## Introduction to Foreign Exchange Markets

The Foreign Exchange Markets are far reaching, diverse and volatile. This diversity spans everything from trading in Goods and Services right through to usage in loans and speculation. For any Organisation whose operation involves buying and selling currency, a clear understanding of the processes and tools available and the impact currency movements can have is essential.

## Why is it Important?

The Currency markets are arguably the most volatile of the markets and large fluctuations can occur on a daily basis. For example, on a £100,000 transaction against a 2% movement in the currency will move the buy price or sell price of the given product or service by £2,000. The currency markets trade 24 hours a day and are influenced by political and economic events. Whilst it is impossible to predict exactly what will happen in the future, a healthy understanding of what tools are available and how they can be applied can prevent unnecessary losses on currency transactions.

Purchasing currency is based primarily on two main types of contract; Spot contracts and Forward contracts.

## Spot and Forward Contracts

The Spot Contract is the most basic and commonly used foreign exchange product. It is an agreement to buy or sell one currency in exchange for another. You have 2 days to settle the contract, at a price based on the prevailing "spot exchange rate" the current value of one currency compared to another.

Although the spot market lets you buy or sell currency as you need it, spot exchange rate movements are highly unpredictable, even during a single trading day. Upon receipt of cleared funds currency is available for onward transmission.

A Forward Contract lets you buy or sell one currency against another, for settlement no later than on the day the contract expires. Unlike spot contracts, a forward contract eliminates the risk of fluctuating exchange rates by locking in a price today for a transaction that will take place in the future (up to a maximum of 2 years). Most importantly it protects you from unfavourable movements in the market, however, be aware that it will not allow for gains to be made should the exchange rate move in your favour during the period between entering the contract and final settlement for the currency. A forward contract does offer the flexibility to take delivery of your currency before the expiry date of the contract.

Often a deposit is required (10%) to secure the contract and is payable within two working days with settlement due on the day the contract expires.

A forward contract is particularly useful for Importers and Exporters as it

offers the purchaser the ability to budget precisely for the medium term and forecast without having to gamble and estimate against the fluctuations of the currency markets.

## Risk

If you are an importer or an exporter you will find yourself exposed to an easily identifiable form of exchange risk. This risk manifests itself in the need to buy or sell currency relating to a transaction in return for Sterling. Movements in the exchange rates can work in your favour and increase profitability, but, equally they can also work in the opposite way and seriously damage and erode your profit margin or worse still create a loss.

A less obvious form of risk but still equally relevant is where an overseas client pays in Sterling. If Sterling strengthens too much it may make your products or services too expensive and affect your competitiveness. Therefore by choosing to use Sterling abroad you are just passing the Foreign Exchange risk to your clients, but will still face the same effects of a changing market.

## Managing Risk

With an understanding of the risk involved when dealing with Foreign Exchange you are better placed to consider how to best manage that risk. The key ways are as follows:

- **Do Nothing** – This high risk strategy means relying solely upon a spot contract and one won't know the rate of exchange achievable until the actual point of buying the currency. The volatility and unpredictability of the currency markets makes this strategy high risk and speculative. The markets do move both ways, so it could result in a win (or lose) situation, however it does make budgeting for the future virtually impossible.
- **Secure a Forward Contract** – This will enable you to lock into a rate of exchange the moment you know you have a currency requirement in the future. It will protect you against any market movement, both positive and negative and you will know exactly how much the transaction will cost you. Securing a forward contract with the broker, at higher level of exchange than that agreed with the supplier/purchaser will ensure a profit margin on the exchange rate alone. The benefits extend to being able to calculate budgetary forecasts for at least the term of the Forward contract.
- **Use Currency Options** – The two key tools are a Stop Loss order, which will protect you against adverse exchange rate movements and secure your currency if it falls below a pre-agreed level. The other is a Limit order, which is placed at the top end of the market to secure currency at a specific price that may not be currently available. This type of contract is particularly useful when the markets are moving in a positive direction for you.

The best option for managing currency risk will be different for each organisation as they will have their own specific requirements, limitations and flexibility with which they can reach to.

## Please contact

Exchange My Currency to discuss your Foreign Exchange requirements, the options available and to gain an insight into the Currency Markets.

