

FOREIGN EXCHANGE MARKETS (FOREX, FX)

A Foreign exchange market is a market in which currencies are bought and sold. It is to be distinguished from a financial market where currencies are borrowed and lent.

General Features.

1. O.T.C (Over The Counter)

Foreign exchange market is described as an OTC (Over The Counter) market as there is no physical place where the participants meet to execute their deals. It is more of an informal arrangement among the banks and brokers operating in a financing centre purchasing and selling currencies, connected to each other by tele communications like telex, telephone and a satellite communication network, SWIFT. The term foreign exchange market is used to refer to the wholesale and retail segments of the market, where the dealings take place among the banks. The retail segment refers to the dealings taking place between banks and their customers. The retail segment is situated at a large number of places.

2. Size of the Market

Foreign exchange market is the largest financial market with a daily turnover of over \$2 trillion. Foreign exchange markets were primarily developed to facilitate settlement of debts arising out of international trade. But these markets have developed on their own so much so that a turnover of about 3 days in the foreign exchange market is equivalent to the magnitude of world trade in goods and services. The largest foreign exchange market is London followed by New York, Tokyo, Zurich and Frankfurt.

3. 24 Hours Market

The markets are situated throughout the different time zones of the globe in such a way that when one market is closing the other is beginning its operations. Thus at any point of time one market or the other is open. Therefore, it is stated that foreign exchange market is functioning throughout 24 hours of the day. However, a specific market will function only during the business hours. Some of the banks having international network and having centralized control of funds management may keep their foreign exchange department in the key centre open throughout to keep up with developments at other centers during their normal working hours.

4. Efficiency

Developments in communication have largely contributed to the efficiency of the market. The participants keep abreast of current happenings by access to such services like Dow Jones Telerate and Teuter. Any significant development in any market is almost instantaneously received by the other market situated at a far off place and thus has global impact. This makes the foreign exchange market very efficient as if they function under one roof.

5. Currencies Traded

In most markets, US dollar is the vehicle currency, Viz., the currency used to denominate international transactions. This is despite the fact that with currencies like Euro and Yen gaining larger share, the share of US dollar in the total turn over is shrinking.

6. Physical Markets

In few centers like Paris and Brussels, foreign exchange business takes place at a fixed place, such as the local stock exchange buildings. At these physical markets, the banks meet and in the presence of the representative of the central bank and on the basis of bargains, fix rates for a number of major currencies. This practice is called **fixing**. The rates thus fixed are used to execute customer orders previously placed with the banks. An advantage claimed for this procedure is that exchange rate for commercial transactions will be market determined, not influenced by any one bank. However, it is observed that the large banks attending such meetings with large commercial orders backing up tend to influence the rates.

Participants

- i.) Corporates
- ii.) Commercial banks
- iii.) Exchange brokers
- iv.) Central banks
- v.) Wealthy individuals.

FOREX EXCHANGE COMPARED TO OTHER FINANCIAL MARKETS

So, what is FOREX trading market?

The basic concept behind the foreign exchange (or forex) market is for trading currencies, one pair against another. It's the world's largest market, consisting of almost \$2 trillion in daily volume and is growing rapidly. The value of one currency is determined by its comparison to another currency via the exchange rate. The major currencies traded most often in the foreign exchange market are the euro (EUR), United States dollar (USD), Japanese yen (JPY), British pound (GBP) and the Swiss franc (CHF). These combine to form the most commonly traded currency pairs:

- EUR/USD
- USD/JPY
- GBP/USD
- USD/CHF

CLARIFICATION:

The first currency of a currency pair is the **base currency**; the second currency in the pair is the **counter currency**. One can think of currency pairs as a single unit. When buying a currency pair, the base currency is being bought, while the counter currency is being sold. The opposite is true when selling a currency pair. Foreign currency trading is conducted without a central exchange, but instead is traded over-the-counter (OTC). Unlike other markets, this decentralization allows traders to choose from a large number of different dealers or brokers (XM, Avatrade Q-option etc) with which to place trades. This also provides the means to compare prices and pip spreads before buying or selling. A number of tools and charts are used in forex currency trading and trader uses these tools extensively to perform accurate analysis to determine whether to buy or sell a given currency pair.

The forex market is operated in Europe, Asia and the United States in overlapping shifts, so currencies are constantly traded 24 hours a day. No single entity has the capability of influencing the market – at least for very long. Currency trading – at its most basic definition – is the act of buying and selling (trading) different currencies of the world. A typical scenario might go something like this: A trader is looking at the British pound (GBP) and U.S. dollar (USD).

This is called a currency pair. The GBP is the base currency, and the USD is the secondary currency. News that the value of the GBP is up from previous reports creates a positive reaction and a spike in the value of the GBP. This, in turn, will cause a rally on the GBP/USD currency pair. If the opposite occurred, and a positive announcement for the USD was reported, then the GBP/USD currency pair will fall, or dip. Either scenario can offer up a profit, depending on which part of the currency pair is bought or sold. The price of each currency within the pair is determined by a number of factors, such as changes in political leadership, economic booms or busts, even natural disasters.

FUNCTIONS OF THE FOREIGN EXCHANGE MARKET-TRANSACTION ASPECTS.

The foreign exchange market is the mechanism through which a person or firm transfers purchasing power from one currency to another or provides credit for international trade transactions and/or minimizes exposure to the risk of changing exchange rates

1. **Transfer of purchasing power** – in international trade, normally parties living in different countries are involved with different currencies. Since each wants to deal with one currency and since the trade /transaction must be invoiced in only one currency, then purchasing power must be transferred from one currency to another.

Example.

A Kenyan firm buying an automobile from Japan must pay in Japanese yen. Therefore the Kenyan firm must transfer purchasing power from Kenyan shilling to Japanese yen or must exchange Kenya shillings for Japanese yen to settle the purchasing price.

2. **Provision of credit**;-Provision of bankers' acceptances and settlers of credit to finance goods in transit.

3. **Minimizing foreign exchange risk**- fx market provide facilities for transferring foreign exchange risk (exposure) to someone else e.g. forward contracts etc.

TRANSACTIONS IN THE INTERBANK MARKET.

Transactions in the interbank market can be executed on a:-Spot, forward and swap basis.

1. Spot transaction (form spot market)

Spot Market-The term spot exchange refers to the class of foreign exchange transaction which requires the immediate delivery or exchange of currencies on the spot. In practice the settlement takes place within two days in most markets. The rate of exchange effective for the spot transaction is known as the spot rate and the market for such transactions is known as the spot market.

A spot transaction in the interbank involves the purchase of foreign exchange with the delivery and payment between banks to take place normally on the second following business day. The date of settlement is referred to as the value date.

Example: A typical spot transaction in the interbank market.

A Kenyan bank contracts on Monday for the transfer of £ 10,000,000 to the account of a London bank. If the spot exchange rate was Kshs 110/£,the Kenyan bank would transfer s£ 10,000,000 equivalent to the London bank on Wednesday and the London bank would transfer s£ 10,000,000 to the Kenyan bank's payee on the same day.

A spot transaction between a bank and its customer would not necessarily wait for two days for settlement.

2. Forward transactions.(form forward market)

Forward Market-The forward transactions is an agreement between two parties, requiring the delivery at some specified future date of a specified amount of foreign currency by one of the parties, against payment in domestic currency by the other party, at the price agreed upon in the contract. The rate of exchange applicable to the forward contract is called the forward exchange rate and the market for forward transactions is known as the forward market.

An outright forward transaction requires delivery at a future value date of a specified amount of one currency for a specified amount of another currency. Exchange rate is established at the time of agreement. Payment and delivery are not required until maturity. **i.e. one, three, six and 12 months.**

Buying forward and selling forward could be used to describe same transaction, thus:

A contract to deliver Kenya shillings for dollars in six months is both:-

- Buying dollars forward for Kenya shillings, and
- Selling Kenya shillings forward for dollars.

3. Swap transactions.

A swap transaction in the interbank market involves the simultaneous purchase and sale of a given amount of foreign exchange for two different value dates. Both the purchase and sale are carried out by the same counterparty. A common swap is a “spot against forward” i.e. the dealer buys a currency in the spot market and simultaneously sells the same amount back to the same bank in the forward market. This way, the dealer incurs no unexpected foreign exchange risk since this agreement is executed as a single transaction with one counterparty.

FOREIGN EXCHANGE RATES AND QUOTATIONS.

A foreign exchange rate is the price of one currency expressed in terms of another currency. A foreign exchange quotation is the statement of willingness to buy or sell at an announced rate. Quotes are often given as the home currency price of the foreign currency and are also given for many currency pairs. However this practice is not uniform worldwide. The professional interbank market has **standardized** its quote system.

Interbank quotations.

The approach adopted to quote FX depends on the criteria used

a) Based on mathematical expression

- i) Direct
- ii) Indirect

Foreign exchange rates are at times described as direct and indirect. The home base or country of the currencies being described is critical.

- Direct quote=home currency ‘**price**’ of one unit of foreign currency. (eg. 1USD=Kshs 75/=). That is X amounts of home currency represent the price of 1 unit of a foreign currency

- Indirect quote=foreign currency ‘**price**’ of one unit of home currency (Is the reciprocal of direct quotation).

Therefore the form of quotation changes with what the speaker regards as “home”.

Kes 75/\$ is the direct quotation in Kenya. It is the Kenyan home currency price (ksh) of a foreign currency(dollar)

Therefore; Kes 75/\$ is the indirect quotation in USA. It is the foreign currency price (ksh) of a unit of home currency (\$)

The reciprocal of the above quote i.e.\$0.0133/KHS is direct quotation in the US and indirect quotation in Kenya. The above quotation \$0.0133/kes is also referred to as the external value the Kenyan shilling i.e. the value of one \$ outside Kenya. The internal value of the Kenya shilling is kes 75/\$-the number of Kenya shillings that can be purchased for one dollar

European terms (Indirect) =expresses the rate as the **foreign currency price** per one unit of the home currency. e.g. DM 1.5625/\$ where dollar is the home currency which means 1.5625 Marks per dollar.

American terms (Direct) =expresses the foreign exchange rate of the home currency price of one unit of the foreign currency. e.g. \$ 0.6400/DM reads as 0.6400 dollars per Mark.

Note that the above terms are reciprocal. Kenya uses the American terms, that is kes 75/\$, KSHS 110/£ etc. The number of Kenya shillings per one foreign currency.

b) Buy Sell-Quotation Approach

- i) Bid
- ii) Ask

Interbank quotations are given as bid and offer. The offer is also referred to as the ask price. The **BID** is the price (i.e. the exchange rate) in one currency at which a dealer will **BUY** another currency. An **offer** is the price (i.e. the exchange rate) at which a dealer will **sell** the other currency.

Note: dealers bid (buy) at one price and offer (sell) at a slightly higher price making their profit from the spread between the buying and the selling prices

Opposite currency.

A trader seeking to buy dollars with marks is simultaneously seeking to sell marks for the dollar. For example, the following quotations were given by a banks FX trader.DM/\$, euorpean quotation.

	Bid	Offer
Spot	1.5625	1.5635.

This means that the FX trader will:-

Buy dollars (i.e. sell marks) at bid price of DM 1.5625 per dollar.

Sell dollars (i.e. buy marks) at offer price of DM 1.5635 per dollar.

The heading outright quotation means that the FX price to all of its decimal points is given. For example DM 1.5625/\$. However, telephone and video screens are abbreviated thus:

The first quotation of bid spot price of DM1.5625 may be given in full but the second term the offer for spot marks would be expressed as the digits that differ from the bid. Hence the bid and offer for spot marks may be expressed as:

Video screen=1.5625-35 on a video screen or,
 Telephone =trader might say 1.5625 pause 35 (pips)
 1.5625 to 35 or

Simply 25 to 35 assuming the leading digits are already known.

When quotations in European terms are converted to American terms, **bid and offer reverses**. The reciprocal of the bid becomes the offer and the reciprocal of the offer becomes the bid. Example;-the reciprocal of the bid DM 1.5625/\$ becomes the offer of \$0.6400/DM. The reciprocal of the offer DM 1.5635/\$ becomes the bid of \$0.6396/DM.

EXPRESSING FORWARD QUOTATIONS ON POINT BASIS.

Among themselves, foreign exchange traders quote forward rates in terms of points referred to as “swap points”

A point is the last digit of a quotation-convention dictating the number of decimal points. Some are quoted to four decimal points e.g. US dollar while others such as Yen are quoted to two decimal points. A point is equal to 0.0001 of most currencies (US). A forward quotation expressed in points is not a FX rate. It is the difference between the forward rate and the spot rate. Consequently the spot rate can never be given in points.

	Bid	Offer	(Bid-points >offer-points)
Outright spot	1.5625	1.5635	
Less points	<u> 175</u>	<u> 169</u>	
Outright forward	1.5450	1.5466	

The three months points’ quotation of “175-169”expresses the forward rate as the number of points away from the outright spot rate.

“175” refers to points away from the outright spot bid.

“169” refers to points away from the outright spot offer.

- When the bid in points is larger than the offer in points, the trader knows that the points should be subtracted and the forward quotation is at a discount.
- If the bid in points is smaller than the offer in points, the trader knows that the points should be added and the forward quotation is at a premium.

ILLUSTRATIONS; quoting a forward exchange rate

A forward exchange rate might be higher or lower than spot rate. If higher, the quoted currency would be cheaper forward than spot (Note we are using indirect quote) for example. Assume a foreign currency is quoted against Sterling pound as follow:

Spot rate: £1: F2156-2166 Discount added
3 months forward £1:F2207-2222

Required

- a) Determine the amount of Sterling Pound required to buy (banks sells) 2 million foreign currency
 - i. at spot rate
 - ii. 3 months time under forward exchange rate
- b) Compute amount sterling £ one would get if he was to sell (banks buys) 2 million of foreign currency
 - i. at spot rate
 - ii. 3 months time under forward exchange rate

Solution

Home currency-£

- a) The bank sells F2,000,000
 - i. at spot rate = $\frac{2,000,000}{2156} = \text{£}927.64$
 - ii. in 3 months = $\frac{2,000,000}{2207} = \text{£}906.21$
- b) The bank buys F2,000,000
 - i. at spot rate = $\frac{2,000,000}{2166} = \text{£}923.36$
 - ii. in 3 months = $\frac{2,000,000}{2222} = \text{£}900.09$

In both cases the foreign currency is worth less against (cheaper) £, in forward contract that at the currency spot rate. This is because it is quoted forward at a cheaper rate or at a discount

against £ (Sterling). If forward exchange rate is lower than spot rate, then the quoted currency would be more expensive forward than spot.

NB: A discount is added to a spot rate and a premium is subtracted from a spot rate. (Indirect quote)

Example

Spot £1: DM 3.05-3.06

The 3 months forward £1: DM 3.03-3.04½

Under such a case, DM is more expensive forward than spot and is said to be quoted at a discount.

Forward rate are not quoted independently but as adjusted to spot rates.

If forward rate is less expensive than spot rate, it is quoted as a premium to spot rate. The forward rate would be higher than spot rate by amount of premium.

FORWARD QUOTATION IN PERCENTAGE TERMS.

Forward quotations can be expressed as a percent per annum deviation from the spot rate. This allows comparison of premiums and/or discounts in the forward market with interest rate differentials. The percent premium or discount depends on which currency is home or base currency.

The base (home) currency.

Quotation given as

	Foreign currency/Home currency	Home currency/Foreign currency
Spot rate	¥105.65/\$	\$0.009465215/¥
Three month forward	¥105.04/\$	\$0.009520183/¥

CASE A;

DIRECT QUOTATION i.e. home currency price for a foreign currency. The formula for percent premium or discount ($f^{\text{¥}}$) is:

$$f^{\text{¥}} = \frac{\text{forward-spot}}{\text{Spot}} * \frac{360}{n} * 100$$

Where “n”=number of days in the contract (in months=# of months)

$$f^{\text{¥}} \text{ for 90 days} = \frac{0.009520183 - 0.009465215}{0.009465215} * \frac{360}{90} * 100 = +2.32\% \text{ p.a.}$$

The sign is positive indicating that the forward Yen is selling at a 2.32% per annum premium over dollar.

INDIRECT QUOTATION=Quotations expressed in foreign currency terms.

When the foreign currency price of the home currency is used the formula for the percent p.a premium or discount becomes:

$$f^{\text{¥}} = \frac{\text{Spot-Forward}}{\text{Forward}} * \frac{360}{n} * 100$$

Substituting ¥/\$ spot and forward rates:

$$f^{\text{¥}} = \frac{105.65 - 105.04}{105.04} * \frac{360}{90} * 100 = +2.32\% \text{ p.a.}$$

The sign is positive indicating that the forward Yen is selling at a 2.32% per annum premium over dollar

CROSS RATES:

Currencies which are inactively traded have their exchange rates determined through their relationship to a widely traded third currency.

Example:

A South Korean importer needs Danish Krone to pay for purchases in Copenhagen. The Korean won (w) is not quoted against the Danish Krone (Dkr). However; both are quoted against the US dollar. Assume the following quotes.

Korean won w808.80/US \$
Danish Krone Dkr5.8705/US\$

Note: the Korean importer can buy one US dollar for W808.80 and with that dollar by Dkr 5.8705. The cross rate calculation would be:

$$\begin{aligned} \frac{\text{Korean won/US dollar}}{\text{Danish Krone/US dollar}} &= \frac{\text{W808.80}}{\text{Dkr5.8705}} = \text{W137.7736.} \\ \frac{\text{Danish Krone /US dollar}}{\text{Korean won /US dollar}} &= \frac{\text{Dkr5.8705}}{\text{W808.80}} = \text{Dkr0.007251.} \end{aligned}$$

INTERMARKET ARBITRAGE

Cross rates can be used to check opportunities for inter-market arbitrage:

For instance, the following FX quotations are given,

Bank of America: Dutch guilders (fl) per US dollar fl1.9025/US dollar

Dominion Bank: Canadian dollar per US dollars C\$1.2646/Us dollar.

ABN Amro Bank: Dutch guilders (fl) per Canadian dollar fl1.5214/C\$

The Bank of American/Dominion Bank cross rate is:

$$\frac{\text{fl1.9025/US \$}}{\text{C\$1.2646/US\$}} = \text{fl 1.5044/C\$}.$$

The cross rate is not equal to ABN Amro Bank/Dutch guilders quotation of fl1.5214/C\$.

So profit opportunity exists from arbitrage between the three markets. Hence triangular arbitrage

TRIANGULAR ARBITRAGE

Therefore a trader with fl 1,000,000 could do the following to take advantage of the apparent arbitrage.

Step 1: sell the sum spot to Bank of America for US\$525,624 (I.e. fl1, 000,000/1.9025)

Step 2: simultaneously sell these US dollars to Dominion Bank for C\$664,704. (I.e. US\$525,624*1.2646=C\$664,704.

Step 3: Trader simultaneously exchanges Canadian dollars at ABN Amro Bank for fl1, 011, 281. (I.e. C\$664,704*1.5214=fl1, 011,281)

Profit on this arbitrage transactions:-

fl1, 011,281-fl1, 000,000=fl 11,281., which is risk free.

CONCLUSION.

Such inter-market arbitrage will continue until equilibrium is re-established i.e. until the calculated cross rate equals the actual quotation less a margin for transaction costs.

Factors influencing supply and demand market forces

- 1) Interest Rates
- 2) Economic Growth (GDP)
- 3) Trade Balance

- 4) The rate of inflation
- 5) The Rate of Unemployment
- 6) Political stability
- 7) Central Bank Actions / The Monetary Policy
- 8) Market factors
- 9) Natural disasters
- 10) Currency Speculation

EXCHANGE RATE SYSTEMS

It is possible for a country to adopt a variety of exchange rate mechanism. The two build systems are:

- a) Fixed exchange rate system
- b) Floating

In practice, it is unlikely that the exchange follows a completely fixed exchange rate system or an entirely free floating exchange system

The real issue is the degree of fixity in an exchange rate system and degree to which governments are prepared to regard a given exchange rate as an objective foe economic policy.

- a) Growth of international trade
- b) Correction of financing of balance of payment
- c) Conduct of domestic economic policy

a) Fixed exchange rate system

Under this system, government endeavor to maintain exchange rate of currency within a specific narrow band. Under fixed exchange rate, government authority will have to operate in foreign exchange market to ensure market rate of exchange is kept to place very near to its fixed (par) rate. However, within such systems there are distinctions as to the form reserves are kept and degree of fixity in exchange rate. The government (Central bank) will have to maintain official reserves required in order to:

- i. Finance any current account deficit (this result in a fall in reserves or surplus) this results in rise in reserve.
- ii. To intervene in the forex market to maintain “par” value of currency. The currency would be bought with reserve if exchange rate fell and sold if exchange of reserve of exchange rate rises

The reserves may take different forms.

Note

- Because the system of fixed exchange rate eliminates fluctuations in exchange rate, it reduces currency risk faced by company, therefore encourages a high level of international trade.
- The absence of flexibility in exchange rate means that the balance of payment deficit will not be automatically corrected. Since deficit cannot be financed forever, government will have to use deflationary policies to depress the demands for imports (slow the growth of economy)

Fixed exchange rate places constraint on government policies. For example. government not allow country’s inflation rate to exceed that of its trading partner, since this will cause current

account deficit on balance of payment and lead to downward pressure on exchange rate. This constraint is known as policy discipline

Advantages of fixed exchange rate

1. Stabilize export proceeds and may stimulate exports stabilize.
2. Will encourage foreign investment and since investors gauge their return on stable return on investment.
3. Keeps inflation under control (imported inflation) since price of imports remain stable.
4. Ability to plan long term investments with accuracy.
5. Government can meet its development plans whose budget are financed using local currency but may be financed by foreign loans and grants.

b) Floating rate exchange system

Under this system, the government has no obligation to maintain rate of exchange at soon declared level therefore leads its determination on market force.

However there is degree to which government will allow market forces to determine the exchange rate.

Types of floating exchange rate

1. Free floating exchange rate
 - Under this system, government would leave the determination of exchange rate entirely on market forces. There will be no official intervention in forex market, thus in need to keep any official reserve.
 - Such a system is rarely because changes in exchange rates have important domestic implications especially where trade ratios are large. For example
 - i. Currency appreciation reduces international competitiveness thus have employment and output implications (reduction of employment and output).
 - ii. Currency depreciation raises the import prices and therefore has implication on rate of inflation (imported inflation)
2. Managed floating exchange rate

Under managed floating, government allows market forces to determine day to day movement in exchange rate but may intervene to prevent very large production. For example:

- Government may allow exchange rate to fluctuate between very large banks (not publicly stated) but intervene if currency looks like moving outside these banks.
- The government may allow market to determine the trend in exchange rate but intervene to limit fluctuation around the trend.

Note

1. Since there is great movement of exchange rate, there is a possibility of currency risk. This may lead to lower volumes of international trade which may imply a reduced level of economic activity.
2. Under free floating exchange, the balance of payment deficit are automatically corrected by movement in exchange rate e.g. deficit leads to a fall in exchange rate

- that improves competitiveness and correct deficits. Thus there is no need for government to hold free reserves to finance payment disequilibrium.
3. Since balance of payment is self-correcting, this removes constraints on government policy making (no need for policy discipline)

FACTORS AFFECTING FOREIGN EXCHANGE RATES

1. Interest rate differential (international fisher effect)

The difference between interest rates and different markets.

The interest rate parity theorem states “ difference in interest rates in markets could cause flow of funds from markets with low interest rates to markets with higher interest rates”.

It is explained by:

$$\%E(\pounds) = \frac{I(h) - I(f)}{1 + I(f)}$$

Where: %E(£) is the percentage change in direct quote of a currency.

I(h) is the interest rate in the home market.

I(f) is the interest rate in foreign market

Illustration

Assume direct quote between D.M. and \$ is:

1D.M. : \$0.5, while general interest rate in U.S.A is 6% and in Germany it is 3%.

Required

Compute large change in the direct quote and the new exchange rate assuming U.S.A is the home country.

Solution

$$\%E(\pounds) = \frac{0.06 - 0.03}{1 + (0.03)} \times 100 = 0.02913 = 2.913\%$$

New direct quote

1D.M: \$50(1-0.02913)

= 1D.M: \$0.4854

The \$ has become stronger.

2. Inflation Rate Differential (Purchase power parity Theorem)

The parity between purchasing power of two currencies establishes the exchange rate of the two currencies. When inflation rate changes, exchange rate must change to reflect the inflation rate differential.

$$\%E(\pounds) = \frac{I(h) - I(f)}{I + J(f)} \times 100$$

Illustration

Assume direct quote between \$ and £ is

£1: \$1.5. The inflation rate in U.K is 10% and in U.S.A it is 6%.

Required

Compute percent change in direct quote and determine new direct quote. (Home market is U.S.A)

$$\%E(\text{£}) = \frac{0.06 - 0.10}{1+0.10} \times 100 = -3.636\%$$

Non direct quote

£1: 1.5(1-0.03636)

= £1: \$1445

The dollar has become stronger (inflation rate is lower).

3. Balance of Payment

If a country has high exports, the importing country will have a higher demand for the currency of exporting country.

Value of currency of exporting country will appreciate and vice versa.

4. Political Stability

With unstable political climate, investors will lose confidence local.

They wish to invest or buy currency of stable countries.

Currency of more stable countries will appreciate and vice versa.

5. Government Policy

A government through its central bank may intervene in foreign exchange market to buy and sell its currency to support its relative to others.

A country may also pursue a policy of undervaluing currency to promote cheap exports.

FOREIGN EXCHANGE EXPOSURE/RISK

- a) Political risk
- b) Cultural risk
- c) Exchange risk
- d) Legal risk
- e) Financial risk
- f) Product and Competitor risk
- g) Technological risk
- h) Market risk

TYPES OF FOREIGN EXCHANGE RISK (EXPOSURE)

Foreign exchange risk is present whenever some of a company's assets are not dominated in the currency of its home currency. There exist three major types of exchange risk (exposure)

1. Transaction exposure
2. Translation exposure
3. Economic exposure

1. Transaction Exposure

- This occurs when the value of a future cash flow (in or out) is known with certainty and requires a foreign exchange transaction.
- For example, a Kenyan exporter who will receive Uganda shillings in 90 days as payment for a sale made today faces a transaction exposure.

2. Translation (Accounting) Exposure

- This is the possibility that a multinational company may suffer a decrease in assets values due to devaluation of a foreign currency even if no foreign exchange transaction occurs.
- Accountants generally agree that transaction exposure should be measured so that the financial statements reflect change in value.

3. Economic Exposure

- This is the probability that changes in foreign exchange rates will decrease the intrinsic (or capitalized) value of the firm.
- Since the intrinsic value of the firm equals the sum of the present value of future cash flows discount at the investors required rate of return, the risk contained in economic exposure requires a determination of the effects of changes in the exchange rate on each of the expected cash flows.
- The measurement of economic exposure requires a detailed analysis of the effect of the exchange rate change on each of the future cash flows rather than on the present assets and liability structure.