Why Currency Markets Move & What You Can Do About It

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Managing currency risk in volatile markets

Managing a cross-border business brings with it a range of opportunities for growth, as well as some challenges!

An informed approach to managing global payments and foreign currency exposure—for one payment or thousands—will benefit your business, saving time, protecting your bottom line, and allowing you to take advantage of new opportunities.

The foreign exchange market can feel, well, 'foreign'. What moves markets? Why does one currency weaken and another rise? In the following pages, we'll discuss some of the causes and effects of currency volatility, and strategies for staying on top of your foreign currency exposures and mitigating risk.

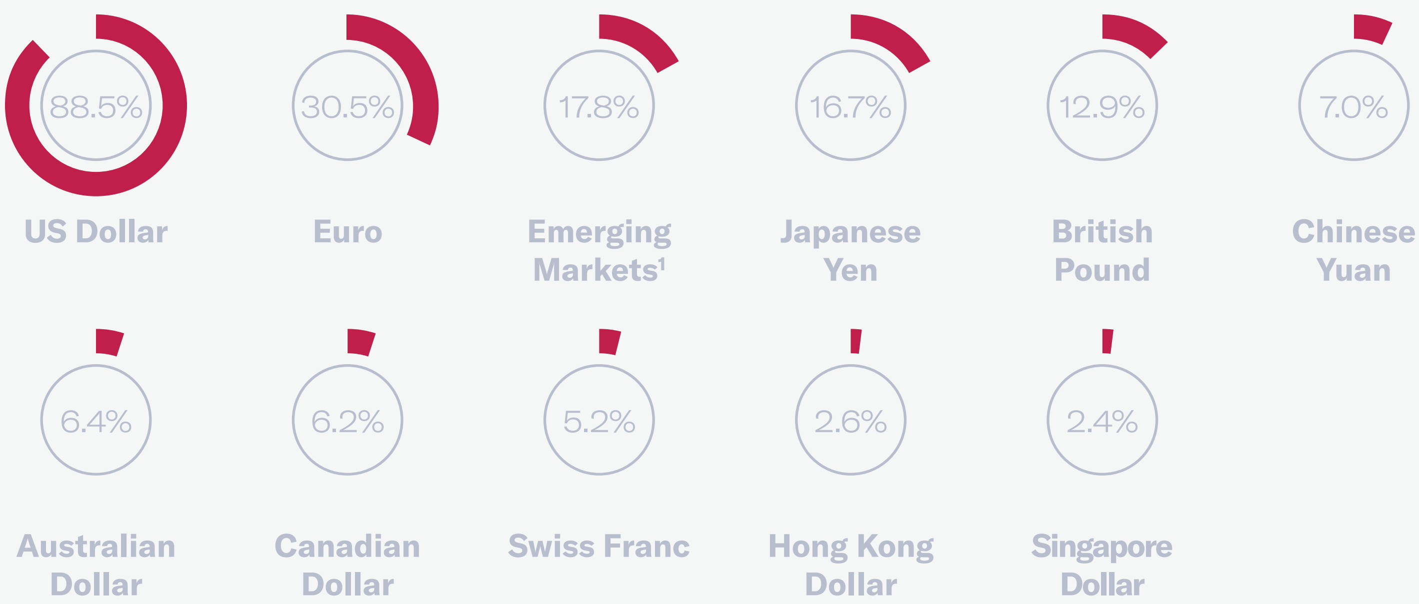
About the foreign currency market

The foreign currency market is the largest and most liquid of the financial markets, trading round the clock six days a week with a daily volume up to US $7.5 trillion. Largely self-regulated, with no central bank, it's often described as an "imperfect" market as participants are there for different reasons and buyers and sellers don't all have the same information (though there are no truly perfect markets outside of your Econ 101 textbook).

Participants include central banks, sovereign funds and liquidity providers; brokers; speculative traders (programmatic and individual traders); merchants large and small, multinational corporations. Others are sending and receiving cross-border payments for goods and services; still others are buying banknotes for travel.

Until the advent of the internet, the forex market was dominated by banks. Digitalization revolutionized many industries, including the foreign exchange market, as it opened it up to more players and more innovation.

The most traded currencies



[1] Emerging market economy currencies excluding the Chinese renminbi and Russian rouble: AED, ARS, BGN, BHD, BRL, CLP, COP, CZK, HKD, HUF, IDR, ILS, INR, KRW, MXN, MYR, PEN, PHP, PLN, RON, SAR, SGD, THB, TRY, TWD and ZAR

Source: Bank for International Settlements (BIS) Triennial Central Bank Survey 2022

Technology, easy air travel, new trade agreements, demand for raw materials, parts and manufacturing facilities around the world for products that are then sold globally: all these factors have made the world smaller. Mature economies are on the hunt for new resources as well as new markets for goods and services. Emerging markets are hungry for exposure for THEIR goods and services—and conversely, for global goods to purchase—as they seek a place on the larger stage.

Sources of volatility

In an interconnected, globalized economy, several factors cause fluctuation in the relative value of currencies. Geopolitical and economic shocks, political and social instability, the fundamental health of the underlying economy, interest rates and inflation, and the balance of trade can all cause currency movement. Some state economies are heavily dependent on one particular export product or commodity, and when prices change it can be disastrous for the economy (look at Russia and Venezuela, which are oil exporters).

In some cases, even a hint of instability or change in monetary policy can cause fluctuation. What are the implications of a weaker or stronger currency? Here's an example: a weaker currency helps a net exporter as their goods are more attractively priced to sell to other markets, but that currency will not go as far as a strong currency will in the import market.

A globalized marketplace

Depending on what your purpose is in trading in international markets (there's that imperfect market again), you may be subject to different types of risk. Following is a brief discussion of four main types of risk.

Transactional Risk

This occurs when one is exchanging one currency for another to buy or sell goods and services. This is the most common kind of risk, as a change in the underlying currency rates can impact your cost and your revenues.

As an example, a Canadian wheat exporter contracts to deliver US$1 million to an animal feed wholesaler in the United States. The buyer wants to pay in US dollars for the delivery in three months' time. The US dollar is strong at the time of the contract (USD/CAD exchange 1.35), so the exporter calculates that the US$1 million will deliver C$1.35 million. Over the course of the three months, the Canadian dollar strengthens nearly 5%.

When the US$1 million is paid, the grower only realizes C$1.29 million, a loss of C$60,000.

USD Price	CAD/USD	CAD Realized	Difference	% Difference
$1,000,000	1.3500	1,350,000 $		
$1,000,000	1.2900	1,290,000 $	-60,000 $	-4.7%

(Rates for illustration only)

Had the grower bought a forward contract for the incoming US$1 million at the 1.35 CAD/USD rate when he and the buyer negotiated the price, he could have protected his margin.

It could just as easily have gone the other way, but the forward contract gave him certainty on his return.

Translational (Balance Sheet) Risk

This affects the value of assets and liabilities held abroad. Translational risk can occur when a foreign-denominated investment, loan, or asset needs to be valued in the home currency (the 'functional currency') for reporting or accounting purposes. If the relative value of either currency changes from one reporting period to the next, it can show up on the balance sheet as a loss or gain.

Economic Risk

This is caused by external factors, such as a natural disaster, a political shakeup, or dramatic change in monetary policy, and typically affect revenues generated abroad. The COVID-19 pandemic and the conflict in Ukraine are examples of economic risk.

Operational Risk

This can occur at any point in the accounting process. As a business grows and complexity increases, legacy systems and practices for processing transactions, reconciling invoices, and reporting may not keep up. Efficiency (and profits) can be affected by manual errors and the extra time spent to track and correct them; opportunities for growth or investment may be missed as a result.

Managing risk

There are several philosophies about managing currency risk. The 'hope and pray' school of thought is firm in the belief that it all evens out in the end. Trusting to luck, though, is not always the best strategy for business growth in any market, particularly in a high-volatility environment.

It's wise to factor currency risks into your overall business risk analysis, so you can understand the potential impact on the balance sheet. Developing a plan that gives you more certainty about your costs and revenues on both sides of the ledger is an important component of your business strategy going forward.

The first step is identifying the type of risks your business may be exposed to, and then working toward a plan that helps you meet your strategic objectives. You may simply need a facility for making a few payments at a targeted rate, or you may need a multi-currency solution that helps you manage hundreds of payments every month as you expand your supply chain or enter new markets.

There is no one-size-fits-all approach: every case is unique. Your plan should be flexible and adaptable to your changing business needs.

Don't go it alone

Speak to a foreign exchange professional who can give you an objective analysis of your exposures, and recommend tools and approaches to help you manage risk and achieve more positive outcomes.

Beyond your bank's foreign exchange desk, there are foreign exchange specialist companies whose services range from moving money efficiently from point A to point B, to providing market insight and advising on hedging and risk management. It's a good idea to consider what's most important to you and how you like to work, and to keep an open mind as you explore your options.

Do your homework

Advantages of working with a specialist can include more proactive service and richer strategic support, and more transparency on rates. Do take the time to understand the pricing structure and the capabilities on offer. And make sure the specialist is fully licensed, and has depth and experience in the market. Some banks and specialists work through intermediaries and partners, which can delay payments and add to the cost.

Don't discount chemistry: What's most important is that you find a partner who offers the level of service you need, a full portfolio of solutions, and whom you can trust as a resource in navigating the complexities of the FX markets.

Useful Definitions in Foreign Exchange Transactions

Spot Transaction: Purchase of a foreign currency at the prevailing rate to settle a one-time payment for delivery the same day, one day or two days ahead.

Currency Hedging: Planning and implementing policies designed to minimize risk, add certainty, and temper the effects of adverse market movement in cross-border transactions.

Forward Contract: A commitment to buy a foreign currency at a fixed exchange rate on a specific date to fulfill a future obligation, without tying up all your cash flow (a small deposit may be required). Depending on the currencies, you can book forwards for any length of time up to 24 months.

Flexible Forward Contract: A commitment to buy foreign currency at a fixed exchange rate within a specific date range. It can be drawn down at any time for recurring payments obligations. Forward contracts can also help you protect the value of incoming payments, by locking in the rate at which you will exchange the foreign currency for your home currency when it is paid to you.

Interbank Rate: The published rate for currency conversion, based on what the biggest banks charge each other. Consumer and business rates will typically be higher than the interbank. And rates change continually.

Spread: What your provider charges you above the interbank rate for your currency purchase or sale. Spreads can vary depending on the volume and frequency of the payments, and the currency pair itself. Less widely traded currencies are typically more expensive.

Multi-currency Holding Account and Cross-currency Trading: purchase of a foreign currency at the prevailing rate to settle a one-time payment for delivery the same day, one day or two days ahead.

Currency Options: A regulated instrument that gives you the right (but not the obligation) to purchase currency at a fixed rate some time in the future, protecting the downside but allowing you to take advantage of the upside should the market move in your favour. Options can be structured with a premium or without. (Not every provider offers options; talk to an FX options specialist to determine whether this is a suitable product for you.)

About Corpay

Corpay pioneered personalized foreign exchange solutions, providing a tailored approach since 1979. With offices across the America, Europe and Asia- Pacific, we are a trusted business partner to more than 25,000 active individual and commercial clients in a wide range of businesses, facilitating payments in 145 currencies to 200 countries.

With state-of-the-art payments technologies and an unmatched global payments infrastructure, our team of experts tailors our portfolio of foreign exchange and risk management solutions to each client's unique business goals. We help take the complexity out of foreign exchange so you can focus on your business.

To learn more, or to schedule a free, no-obligation risk consultation with one of our industry experts, please get in touch.

Request a call back

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