WORLDFIRST

# Foreign Exchange Markets Explained

A guide to demystifying currency markets for your business

Whether you’re new to international trade or a seasoned cross-border veteran, the ebbs and flows of foreign exchange markets will be a significant factor in the long-term success or failure of your business.

With over 15 years of experience in foreign exchange markets, we’ve collated some of the steps you and your business can take to put you in a better position to tackle the risks of currency markets and trading overseas.

## In this guide:



# 1.

# What are foreign exchange markets?

# 1. WHAT ARE FOREIGN EXCHANGE MARKETS?

Markets exist across the world; from the pottery sellers of Istanbul's Grand Bazaar to purveyors of leather jackets in London's Camden Market. The foreign exchange market, however, is a different beast. More than 6 trillion US dollars changes hands every day in a market that opens on a Monday morning in New Zealand and doesn't close until Friday evening in New York.

In the FX markets, instead of goods, there are different types of currency trades, with the majority involving the US dollar. In fact, almost a quarter of all currency transactions that take place are traders exchanging euros for US dollars (and vice versa). The players and traders that make up this market are widely varied. From national central banks building up or selling their currency reserves to multi-national institutions buying or selling currencies on behalf of their clients.

When these organisations conduct their transactions, they usually trade in very large quantities (in millions of dollars, as opposed to thousands!) which can have a significant impact on the direction of the market price. The price at which these trades take place is known as the interbank rate and it changes at an exceptionally rapid pace to meet the conditions of the market. Only central banks, multi-national banks and a few select others can access this price.

Companies like WorldFirst use this primary network of multi-national banks to buy and sell currencies around the world, effectively creating a secondary foreign exchange market where, instead of big banks trading millions of dollars, smaller businesses and individuals trade smaller quantities of money. In order for companies like WorldFirst to offer this service to smaller businesses and individuals, a slightly different exchange rate is offered. The difference between this rate and the interbank rate is known as the spread and dictates how much money companies like WorldFirst retain from each trade.

**Most traded currencies:**

1. US Dollar (USD)
2. Euro (EUR)
3. Japanese Yen (JPY)
4. British Pound (GBP)
5. Australian Dollar (AUD)
6. Canadian Dollar (CAD)
7. Swiss Franc (CHF)
8. Chinese Renminbi (CNH)
9. Hong Kong dollar (HKD)
10. New Zealand dollar (NZD)

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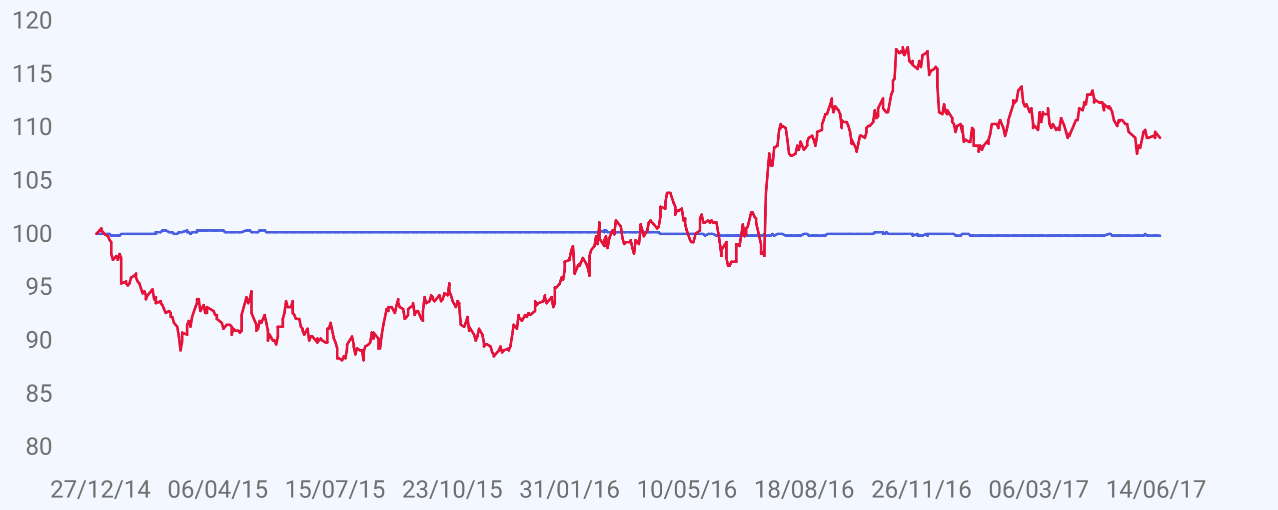
# Why do exchange rates change?

The majority of developed world currencies are free-floating, meaning the value of that country's currency can rise and fall against others as the markets see fit. Of the world's ten most traded currencies, nine of them are free-floating. Currencies can also be managed, or pegged, to other assets including precious metals or even another country's currency.

Managed exchange rates can work to great effect in economies that are closely tied with economies abroad. The recent Swiss, Danish and Czech currency arrangements with the euro are a good example of this.

**Fixed vs. floating exchange rates[1]**




Broadly speaking, free-floating exchange rates follow the laws of supply and demand. If a shift takes place that affects either the demand for or the supply of a currency, the price of that currency will shift also. These 'shifts' can be the result of economic, political or central bank policy changes, or something wholly separate to the economic and financial system.

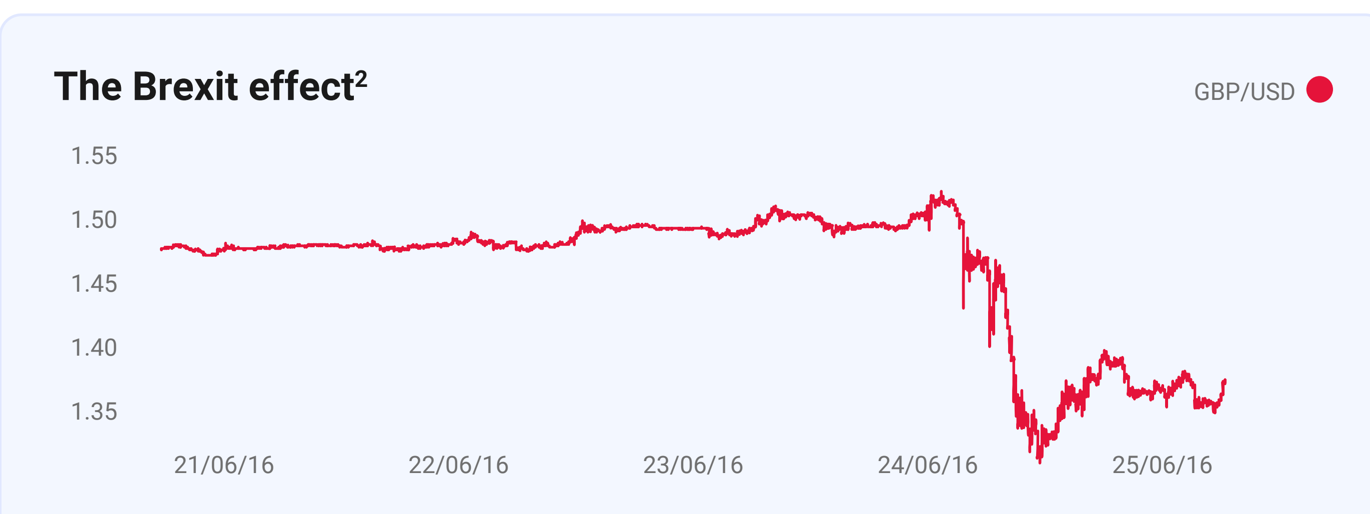
[1]Source: Bank of England/WorldFirst Data

# Economics: data releases

Foregoing longer-term trends, exchange rates can often be subject to short-term volatility alongside data releases by either official statistics agencies (e.g. the UK's Office for National Statistics or the EU's Eurostat) or from private sources (e.g. Markit or ADP). The outcome of the data itself can lift a currency if the numbers shows economic strength or, if the data misses expectations, a currency may weaken. An example of this is the UK's industrial and manufacturing production which earlier this year fell below expectations and weakened the pound.


# Politics: the UK's vote to leave the EU

In the wake of the vote to leave the European Union, the pound suffered its largest single-day drop in history, falling as much as 11% as markets rushed to price in the uncertainty of negotiations, political shake-ups and economic adjustments.

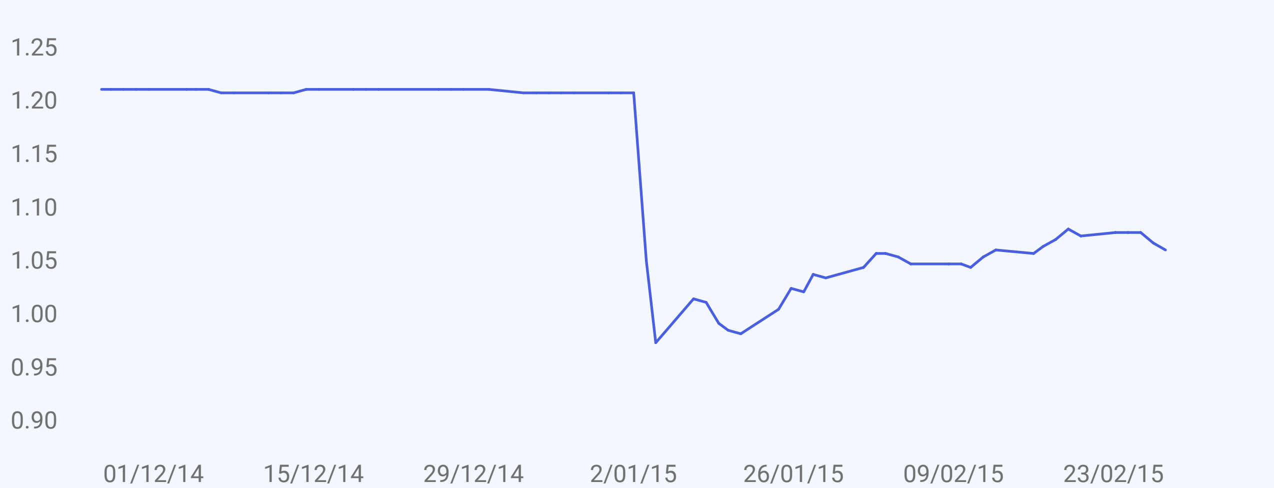



[2]Source: Bloomberg Finance LLP/WorldFirst Data

## The central banks: Swiss National Bank drops the euro peg

In late 2011, the Swiss National Bank faced the dilemma of what they considered an overly strong domestic currency choking off growth and inflation. Given their economic and geographic proximity to the Eurozone, the central bank chose to enforce a 'currency cap' by trading their currency and others in order to prevent the EUR/CHF rate from falling below 1.20. This policy held firm for close to four years. Finally, with relatively little warning, on January 15th 2015 the Swiss National Bank withdrew all support for the cap, prompting the Swiss Franc to strengthen at a rate not seen in decades – EUR/CHF fell by close to 20% in just one day.

**Switzerland slam the euro[2]**



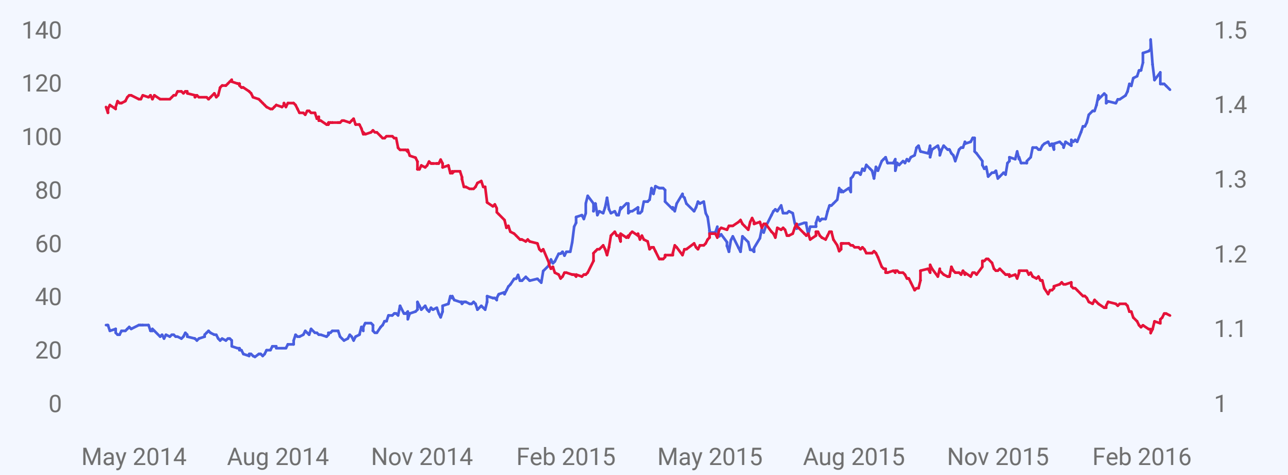

[2]Source: Bloomberg Finance LLP/WorldFirst Data

# Commodities: oil price plummet drags the 'Loonie' lower

The performance of a particular currency is closely allied to the behaviour of that country's economy; if the economy performs well, the currency will often rise in tandem. As such, if a country is particularly dependent on the export of a commodity, the price of that commodity, gold for example, can often dictate the price of the currency. That's the case for Brent oil and Canada, the world's fifth largest producer of crude.

As the price of a barrel of oil plummeted in 2014, the Canadian dollar - known colloquially within markets as 'The Loonie' - followed suit. When oil prices were up at $110 per barrel, one US dollar bought you one Canadian dollar and a few cents, but when oil prices dropped down in the $30s the Canadian dollar fell as much as 20%.

**Oil drags the CAD[3]**




[3]Source: Bank of England/Bloomberg Finance LLP/WorldFirst Data

# Natural disasters: taking a toll on financial markets

On the 11th March 2011, a 9.1 magnitude earthquake struck the eastern coast of Japan, causing as much as $235 billion worth of damage in just six minutes. Despite initial expectations that the Japanese yen should lose value due to the economic fallout of the earthquake, the currency actually strengthened. This was largely as a result of Japanese firms selling up their foreign currency denominated assets (from bonds to equities) in favour of buying the yen and holding cash to deal with the earthquake crisis. In the months following the earthquake disaster, the yen strengthened by over 10%.

## 2011 Tōhoku earthquake strengthened the yen[2]


[4]Source: Bloomberg Finance LLP/WorldFirst Data

# 3.

# How foreign exchange markets can impact your business

Businesses interact with markets overseas in a number of different ways, be it importing machinery from Europe or exporting goods to China. In many circumstances, this will involve either receiving or sending a foreign currency from or to your business partners and so, naturally, your business will have exchange rate exposure.

When paying a supplier, it's this exchange rate exposure that can make a difference to your business. If, for example, you're contracted to pay a French supplier for a shipment of goods in six months' time at a cost of €50,000, every percent of change in the EUR/GBP rate will have a direct impact on your bottom line. At the time of writing, the EUR/GBP exchange rate is around 0.85, making your final bill £42,500 if paid today. However, should the value of the pound fall by 2.5%, EUR/GBP would rise to over 0.87, lifting your supplier payment to over £43,500 – meaning you're paying an additional £1,000 for the same shipment of goods. Nonetheless, should exchange rates move in your favour (the pound strengthening in this example) then you'd end up forking out less for your euro payment.

While supplier payments and exporting are some of the more upfront ways in which exchange rates can affect you and your business, there are a plethora of ways currency volatility can trickle into your business. These are namely transactional, translational, credit and liquidity exposures:

### Transactional

- Forecasted FX exposures
- Accounts payable
- Accounts receivable
- Capital expenditure
- Significant company purchases/M&A

### Translational

- Balance sheet adjustments
- Foreign assets/liabilities
- Tax obligations
- Foreign currency loans

### Credit

- Default risk
- Concentration risk
- Counterparty risk

### Liquidity

- Liquidity events
- Margin calls

It's not the nature of these risks themselves, but how you deal with them that will make a difference to your business. There are a number of different methods and techniques with which to approach currency markets.

4.

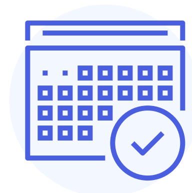
# How to move your money overseas

Now you know the ins and outs of the currency markets; what they consist of, why they change and fluctuate and how this can directly impact your business. But the ways in which you can interact with the currency markets may still leave you scratching your head.

Transferring money can be simple – spot contracts and short-term forwards can be a quick, easy and efficient way of moving your funds from one currency to another. But, this may introduce an element of risk to your business as there's effectively no way of predicting what the exchange rate will be on your future transfers. So how can you know what your profit margins will be in one week, month or even years' time? For some businesses, using hedging strategies or longer-term forwards can trim some of this risk and more complex payment solutions can be more suited. At the end of the day, it all comes down to you, your business and the way you approach foreign exchange.

## Spot contract

A spot contract is the simplest form of international payment. We'll offer you a rate based on a live market rate (or "spot") and you can choose whether or not to transact then and there. With a spot contract you can make a payment very quickly; as soon as you've agreed your rate and we've received cleared funds, we then take care of the rest for you.



## Forward contract

If you want to secure a rate but aren't yet ready to make a transfer, you can choose a forward contract to fix a rate today for a specified date in the future. The great thing about a forward contract is that you know now exactly how much you'll get when you're ready to transfer. It helps you plan and protects you should rates move against you later. However, a forward contract could work against you if rates move in your favour after you have secured a rate. We strongly recommend that you chat through your options with one of our dedicated relationship managers before choosing what's best for you.

If you decide that a forward contract is the best choice for you, we'll ask you to pay an initial deposit so that we can 'hold' this rate for you. The size of the deposit will depend on the currency you want, the amount and when you want it. The deposit will be used towards the balance when you settle the contract. Failure to settle the contract may result in the loss of your deposit, which is why, when choosing a forward contract, you must be certain you have a requirement for the full amount of the currency being purchased. On occasions, we may also ask you to top-up your initial deposit if the exchange rate moves significantly after you've guaranteed your rate. This is called a margin call and will be explained to you in detail by your account manager.

# You can use forward contracts in a number of ways:

## Fixed term forwards

The most common use of a forward contract is with a fixed term. These contracts give you a fixed period over which the exchange rate you receive will be guaranteed at the end of the contract. This period could be as short as five days, to as long as three years.

**WorldFirst books rate** — **WorldFirst pays funds**

**Start** — **End**

**You pay deposit** — **You pay outstanding funds**

## Flexible forward

A flexible forward acts in a similar manner to a fixed-term forward, however you will have the ability to use your forward exchange rate at any point over the lifetime of the contract. This facility can be used numerous times until your nominal trade size (agreed at the beginning of the contract) has been exhausted.

**WorldFirst books rate** — **WorldFirst pays funds**

**Start** — **End**

**You pay deposit** — **You pay outstanding funds**

Ability to trade at the forward rate up to the total trade size at any time across the lifetime of the contract

## Singapore SMEs

Small and medium-sized (SMEs) in Singapore beat APAC counterparts in export earnings. To maintain Singapore's status as an open, global and forward-looking nation, SMEs need to approach international trade and foreign exchange markets with greater confidence and digital adoption (such as e-commerce and automated processes).

## Future challenges

As cross-border trade continues to thrive in Singapore, SMEs will have to navigate through the competition, international logistics cost, custom procedures and foreign currency exchange issues. Recognising these global challenges, WorldFirst is on a mission to make it easy to do business anywhere.

For more information, visit **worldfirst.com/sg/**

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