SES'S L.S.RAHEJA COLLEGE OF ARTS AND COMMERCE

Course: International Finance Unit: iv sem vi Prepared by: Asst. Prof . Mehul Barai

Forex risk is a financial risk that exists when a financial transaction is denominated in a currency other than that of the base currency of the company/country.

Factors responsible for exchange rate risk:

1. Inflation rates:
   Lower inflation rate means appreciation in currency.
2. Interest rate:
   Increase interest rate means appreciation in currency.
3. Balance of payment:
   A deficit Balance of payment causes depreciation in currency.
4. Government debt:
   More debt causes depreciation in currency.
5. Terms of trade:
   Rise in export prices means appreciation in currency.
6. Political stability:
   Stable government appreciation in currency.
7. Recession:
   causes depreciation in currency.
8. Speculation:

Types of forex risk:

1. Transaction risk:
   This is the risk of an exchange rate changing between the transaction date and the subsequent settlement date, i.e. it is the gain or loss arising on conversion.
2. Economic risk:
   It is difficult to quantify but a favoured strategy to manage is to diversify internationally, in terms of sales, location of production facilities, raw materials and financing.
3. Translation risk:
   The financial statements of overseas subsidiaries are usually translated into the home currency in order that they can be consolidated into the group's financial statements.

Forex risk management techniques:

1. Internal techniques:
   a. Invoice in home currency
   b. Leading and lagging (for e.g. if Indian currency will depreciate in future as an exporter, I will lag amount receivable and vice versa)
   c. Matching (suppose all receipts and payments in USD are match and difference is received or paid)

2. External techniques:
   a. Forward contracts
   b. Future contracts
   c. Forex swaps
   d. Options.

Portfolio management guides the investor in a method of selecting the best available securities that will provide the expected rate of return for any given degree of risk and also to mitigate the risk.

Objectives of portfolio management:

1. Security of principal investment
2. Consistency of returns
3. Capital growth
4. Marketability
5. Liquidity
6. Diversification of portfolio
7. Favourable tax status.

Arbitrage:

Arbitrage involves the simultaneous buying and selling of an asset in order to profit from small differences in price.

Speculation:

Speculation, on the other hand, is a type financial strategy that involves a significant amount of risk. Speculators attempt to profit from rising and falling prices.