FOREIGN EXCHANGE AND CURRENCY

An exchange rate (also known as the foreign-exchange rate, forex rate or FX rate) between two currencies is the rate at which one currency will be exchanged for another. It is also regarded as the value of one country's currency in terms of another currency. Exchange rates are determined in the foreign exchange market, which is open to a wide range of different types of buyers and sellers where currency trading is continuous. Exchange rates represent the linkage between one country and its partners in the global economy. They affect the relative price of goods being traded (exports and imports), the valuation of assets, and the yield on those assets. In 1973, foreign currencies decoupled from the U.S. dollar (USD) and became flexible, meaning the market determines these rates based on trade flows, interest rate differentials, differing rates of inflation, and speculation about future events.

As exchange rates fluctuate, the domestic prices of foreign goods will often be affected. If the USD depreciates vis-à-vis a foreign currency, U.S. exports become cheaper and tend to rise, while U.S. imports theoretically become more expensive and tend to fall.

Example: The stronger Brazilian Real (it now takes fewer Reais to buy a USD) or weaker USD (a Dollar now buys fewer Real)- This relationship makes Brazil's goods exported to the U.S. more expensive to buy with USDs. At the same time, it makes goods that the U.S exports to Brazil more affordable to buy with the Real. We would expect this change to lead to an increase in the flow of goods from the U.S. to Brazil. Conversely, if the USD appreciates vis-à-vis a foreign currency, U.S. exports become more expensive and tend to fall, while U.S imports become cheaper and tend to rise.

Most exporters are not interested in speculating on foreign exchange fluctuations and prefer to avoid risks. One of the simplest ways for a U.S. exporter to avoid this type of risk is to quote prices and require payment in USDs, thus placing the burden of exchanging currencies and associated risks on the buyer. Exporters should be aware of potential problems with currency convertibility. Not all currencies are freely or quickly converted into USDs. Fortunately, the USD is widely accepted as a global trading currency, and U.S. firms can often secure payment in Dollars.

While getting paid in USD is preferred, it is not always possible. If the buyer asks to make payment in a foreign currency, the exporter should consult an international banker before negotiating the sales contract. Banks can offer advice on the foreign exchange risks that exist with a particular currency. Some can also help hedge against such a risk, by agreeing to purchase the foreign currency at a fixed price in USD, regardless of the currency's value at the time the customer pays.

In summary, exchange rates, if not carefully considered, can dramatically change the anticipated outcome of a foreign contract. When dealing with large contracts, exporters should always consider currency exchange risk and consider foreign exchange risk management techniques to mitigate any losses due to currency fluctuations.

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