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Strategic Applications of Currency Derivatives in Managing Foreign Exchange Risk

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ABSTRACT: The fluctuations in currency rates are a tangible consideration for organizations engaged in global operations. Given that numerous Swedish enterprises depend on exports, it is essential to safeguard against currency fluctuations. Fluctuations in currency can be rather troublesome; nevertheless, there are numerous strategies to mitigate their impact. A medium-sized firm can mitigate the effects of currency fluctuations on its profitability by employing the strategies defined in this dissertation. Furthermore, we will examine the foreign exchange operations of two Swedish SMEs and explore strategies for optimizing their resource utilization and planning. Two subject matter experts (SMEs) were consulted to enhance our comprehension of the issues at hand. Although cognizant of the significant threat that foreign exchange risk presents to their international operations, the case paper revealed that medium-sized enterprises are failing to implement necessary safeguards. Consequently, the necessity should originate externally, particularly from the banking sector. Businesses must to strategize in advance to mitigate any currency fluctuations. Given that satisfied consumers are more inclined to become repeat patrons, it is economically advantageous for banks to fulfill this expectation. This may result in a universally acceptable solution.

Key words*: Currency risk management, Foreign exchange risk, mid- corp., Transaction exposure.*

1. INTRODUCTION

Corporation makes a decision, the board of directors, management, and shareholders must evaluate the advantages and disadvantages. While risk management has just lately emerged as a significant concept in corporate finance theory, it is not a novel idea. Prior to the incorporation of the term "derivative" into financial terminology, corporate management would assess the advantages and disadvantages of many business strategies, including the issuance of debt or equity, investments, and development initiatives. The majority of management decisions, particularly those related to risk management, impact the company's financial condition, as evidenced by the financial statements. Since the age of Graham and Dodd, the financial sector has always endeavored to ensure the public disclosure of financial statements. Specialists in the domain express concern with the financial sector's convoluted use of risk management strategies, particularly in relation to derivatives. Research on contemporary industry standards indicates that the majority of organizations approach risk management in a fragmented manner, exacerbating the situation. Certain organizations utilize anticipated market conditions to inform their hedging ratios, whereas others meticulously monitor cash flows and the timing of capital expenditures to mitigate risks related to foreign exchange, interest rates, and

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commodity prices. Numerous firms neglect to consider the cumulative impact of inherent risks and derivatives when assessing the efficacy of risk management only based on the performance of derivative contracts. Regardless of the company's designation of "strategic hedging," investors should exercise caution, since this indicates the inherent risks associated with derivatives.

Problem Statement

Foreign exchange risk impacts enterprises engaged in international transactions involving foreign currencies. Companies have undoubtedly implemented a risk management strategy; the pertinent question is its execution efficacy. Large firms typically possess the personnel and resources required to address such issues. Large corporations are not the sole entities confronting this danger; in fact, it exacerbates as their foreign exchange activities expand. Consequently, fluctuations in currency values can impact enterprises of all scales. Our literature analysis and consultations with field specialists indicate a deficiency in their competency in managing it.

Purpose

The major purpose is to mitigate the effects of currency fluctuations on the firm. This paper will examine and detail the foreign exchange operations of two small and medium-sized Swedish enterprises. Furthermore, recommendations will be provided to enhance the utilization of various methodologies and technology.

2. LITERATURE REVIEW

The foreign exchange market is the largest marketplace globally, with the highest trading volume. With daily transactions amounting to trillions of dollars, it is unquestionably the leader in the business. The asset class in issue is available 24/7, throughout the whole year, to all participants, ranging from individual day traders to major multinational corporations. Market trading averages four trillion dollars daily, as reported by McFarlin (2010). He explains that individuals engage in foreign currency trading to capitalize on fluctuations in exchange rates or to mitigate the risks associated with exposure to a specific currency. In his opinion, foreign currency trading serves as a method to achieve these objectives. The primary motivation for his presentation of this argument is his intention to capitalize on fluctuations in exchange rates; the secondary incentive is his aim to mitigate the effects of any adverse consequences associated with a specific currency. Numerous marketplaces exist for currency trading, including spot, forward, futures, and exchange-traded fund (ETF), and options markets. Recent data indicates that the interim market is the primary determinant of contemporary pricing (Rosenberg, 2009). Our research has recently concluded. Numerous firms and individuals continue to engage with a limited array of alternative currencies, as opposed to the dollar. Traders are consequently restricted to evaluating only the dollar's fundamentals, which may be counterproductive in comparison to the fundamentals of the opposing side.

Chelkowski (2010) contends that employing the US dollar as the vehicle currency for cross-pair trading can enhance profitability. This is due to the dollar being the most extensively traded and liquid currency globally. The US dollar's position as the most liquid primary currency accounts for this phenomenon. The majority of interbank transactions in

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the foreign exchange market are speculative and not associated with the actual export or import of products or services, as evidenced by the data presented by Glen Arnold and colleagues in their book Corporate Financial Management. This information is contained in the previously referenced paper. Research published by Ramcharran in 2000 indicates a correlation between currency market volatility and the revenues of trading banks. This offers substantial further evidence supporting the assertion.

3. METHODOLOGY

To provide a comprehensive overview of the various strategies a corporation can employ to mitigate the risks associated with foreign exchange trading. Our objective was to delineate and examine the existing foreign exchange operations of two Swedish mid-sized enterprises and provide insights on optimizing the application of various strategies and instruments. I hoped this action would assist others. This was one of our objectives in addition to investigating and delineating the existing activity. My colleagues and I identified early in the dissertation writing process that numerous medium-sized enterprises inadequately managed the foreign exchange risk they encountered. During the debate, this was a primary argument we presented. Consequently, to establish a foundation for enhanced understanding, we were initially presented with a summary of the previously accessible material. The theoretical foundation of Swedish banks, the foreign currency market, variables influencing exchange rates, the concept of foreign exchange risk, and the instruments for managing exposure to foreign exchange have all been extensively examined.

Research Approach

One may employ either the deductive or inductive approach throughout an investigation. Both methodologies provide value. Saunders et al. (2007) indicate that researchers may employ either of these two methodologies in their investigations. The analyzed data is utilized to execute the selected plan to achieve potential scientific discoveries. The deductive method requires the establishment of preliminary concepts and hypotheses, together with a research strategy to evaluate them. We shall examine one aspect of "deducing" information from the existing data. The inductive method is an alternative designation for this type of inquiry. Inductive approaches entail collecting data and subsequently evaluating it to build a theory regarding the topic under investigation. Saunders et al. (2007) assert that inductive and deductive reasoning can be integrated inside a singular argument.

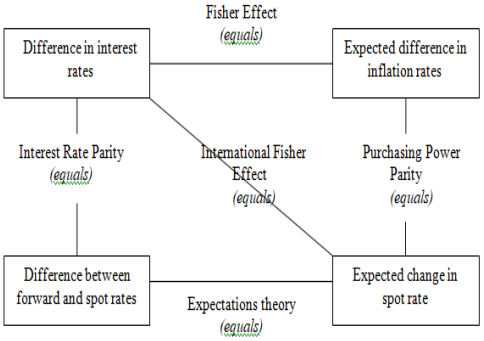


Figure 1: illustrates the four-way equivalence that exists within the market for foreign exchange.

Data

It is possible to distinguish between main and secondary sources of knowledge. The phrase "primary data" was introduced by Christensen et al. (2001) to denote information gathered explicitly for this

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research. To elucidate, "primary data" denotes information specifically collected for the research project, whereas "secondary data" pertains to material previously generated for an alternative purpose, thereby excluding it from being classified as "primary data." The methodology, along with both primary and secondary data, provides essential insights relevant to the research questions and hypotheses, forming the fundamental basis of the paper. The essential data for the research is provided to us by this pivotal foundation.

Primary Data

The approach to primary data gathering and analysis may be quantitative or qualitative, contingent upon the individual's requirements and interests. Quantitative data encompasses any information that can be articulated or assessed numerically. This is an alternative description of quantitative data. Quantitative data" is an alternative term for quantified data in some settings. Tables or diagrams are frequently employed to facilitate the examination of statistical relationships among various variables. The objective of providing the data in this manner is to facilitate comparison. The objective is to facilitate comprehension of the comparison. The phrase "qualitative data" shall be utilized synonymously with numerical and non-quantitative data in this discourse. In essence, quantitative measurements do not represent qualitative data. Qualitative research, emphasizing the underlying significance of obtained data, has developed to include a diverse array of elements such as symbols, texts, language, and behaviors. Qualitative research, conversely, prioritizes the overarching relevance of the acquired data. According to Christensen et al. (2001), maintaining a comprehensive perspective is essential for qualitative researchers. Understanding the problem in its entirety is more critical than examining its individual components.

We choose a qualitative technique to comprehensively understand the subject and assess the current performance of the relevant organizations. We concluded that the most effective method for collecting primary data would be to perform interviews. Interviews can be conducted using one of three formats: semi-structured, structured, or unstructured. Structured interviews are conducted using predefined and pre-formulated questions. To achieve their research objectives, investigators conducting semi-structured interviews typically arrive with a pre-established list of subjects and inquiries. However, the inquiries may arise in an alternate order, and I may pose additional questions to you. Interviews lacking a predetermined structure are less formal than conventional interviews. A predetermined list of questions is unnecessary for respondents to openly engage in discussions regarding relevant events, behaviors, and attitudes (Saunders et al., 2007). The respondent's freedom to articulate the matter in their own terms led to this outcome.

Secondary Data

The process is now officially initiated. We commenced by reviewing prior CRM studies to identify any unexamined domains. The primary objective of our inquiry was to identify unexplored regions. We compiled numerous papers from various journals on topics such as risk theorization, client relationship management, the currency market, and other significant themes within this field of paper. The extensive scope of the customer relationship management (CRM) sector

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appeared to align well with our research objectives. One of our primary objectives was to collect pertinent information; hence, this was essential. Furthermore, it established a robust foundation that enabled us to analyze and differentiate the sources and the authors' perspectives on the subject. Nonetheless, we found that the authors of the books employed a CRM-like methodology. This discovery was quite intriguing for us. Their perspectives were strikingly analogous, employing identical intellectual frameworks and models. As a result, the data collection method has been significantly streamlined. Certain authors have been utilized more extensively by our organization than others; examples include Oxelheim, Shop, Benet, and Buckley. The challenges have been elucidated in greater detail, enhancing their comprehension of the issues. This shift has occurred due to the provision of more extensive descriptions of the concerns.

By utilizing the Internet and the websites of Swedish business institutions, we acquired current information regarding various tools and services that can assist in mitigating currency exchange risk. Consequently, we optimized the utilization of the resources available to us. Prominent among the numerous industry experts with whom we have engaged in comprehensive discussions is Mats Ring of Swanbank Markets. The information provided by Mats regarding the practical applications of various trading methods was concise and direct. Additionally, we contacted Nordau, SEB, and Handelsbanken to solicit information regarding possible CRM requirements and support needs, as well as the measures that enterprises may undertake in response. We endeavored to collect extensive data regarding this issue. Our objective was to have a clearer understanding of the various trajectories that organizations may pursue. Acquiring this data was challenging as certain bank employees were unaware of the requisite actions for the businesses. As a result, acquiring the information got increasingly difficult. Additionally, we sought to explore the deployment of customer relationship management systems by Swedish firms in greater depth. We contacted with the Bank of Sweden, commercial banks, export banks, and several Swedish financial and statistical institutions to acquire this data. Nevertheless, no one has been able to furnish the necessary data due to the scarcity of pertinent industry statistics. The use of secondary data enables us to illustrate the theoretical framework we are now employing. Moreover, the secondary data was crucial for acquiring the primary data.

4. FOREIGN EXCHANGE MARKET

Both companies have had to adapt to survive in the contemporary economy, a consequence of globalization. Fluctuations in the foreign exchange market can also affect enterprises. The efficacy of the foreign currency market relies on the cooperation of all players, despite their individual interests. Both enterprises depend on the foreign exchange market for their daily operations and worldwide commerce. The foreign exchange market has two submarkets: the forward market and the spot market. The forward market facilitates the exchange of currencies for future delivery dates, while the spot market involves the trading of currencies for immediate delivery. X and Y possess

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experience in trading inside the futures and spot markets. Companies X and Y engage in spot market transactions anytime they receive payment in a currency different from their own. The acquisition of financial instruments necessitates involvement in the forward market.

The foreign currency market is characterized by perpetual fluctuations. The market has profited from the diminished currency trading activities of both groups since the Euro's (EUR) inception. The introduction of the Euro has enabled an increasing number of countries to utilize several currencies. Companies X and Y have observed that while conducting business in China, they possess greater flexibility in selecting between the Euro and the Dollar.

Determination of Exchange Rates

The worldwide currency exchange rates result from a complex interaction among several variables. Theoretical discussions encompassed model components. Inflation, interest rates, and currency exchange rates are analyzed in both the short-term and long-term contexts. Each of these factors will influence the global dollar value, subsequently impacting Companies X and Y. Companies X and Y neglect the interdependence of components in their daily operations, despite its potential to enhance long-term performance.

Foreign Exchange Risk

Companies X and Y had to endure a difficult lesson regarding this process. Both companies are vulnerable to numerous risks; but, Company X was more transparent in its disclosures. The operational scope of a business, whether domestic or worldwide, influences the kind of hazards it encounters.

RISKS IN INTERNATIONAL BUSINESS

Commercial Risk

In a transaction where both parties adhere to the regulations, there is no commercial risk. These responsibilities may encompass the financial resources of the buyer's or seller's distribution network, for instance. The joint business operations of Companies X and Y render them susceptible to this danger. Mitigating the commercial risks associated with global business operations may prove more challenging in a conventional environment. Company Y may encounter this difficulty when it receives incorrect orders from abroad. Due to the high cost of shipping, the company endeavors to minimize product returns. Both organizations encounter substantial commercial risk due to their international operations. For instance, Company X mitigated this risk by employing documented letters of credit, whereas Company Y was ambiguous on its similar actions.

Financial Risk

Companies X and Y are in disparate financial situations due to their engagement in distinct economic activities. Due to the great significance placed on prompt payments by company X, it is customary for the company to mortgage its invoices to obtain financing. In comparison to Company X, which possesses more consistent liquidity, Company Y's financial condition is significantly inferior. This occurred due to Company Y's excessive dependence on short-term funding. This is due to the corporation's lack of knowledge on both the amount and the precise date of the payout. Company Y is presently factoring in the interest amount. All business

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operations, whether local or global, are fundamentally laden with financial and economic risks. Nonetheless, overseeing financial risk on a worldwide scale would present a distinctive and formidable challenge.

5. CONCLUSION

The home market in Sweden is small and expanding slowly, which is why businesses are now relying more heavily on exporting than they did initially. Globalization has created new market opportunities for Swedish enterprises that were before inaccessible. While promising new opportunities may emerge, it is essential to remain vigilant regarding the associated hazards. The volatility of currency exchange rates is one such variable. Foreign exchange risk can be managed through various methods. Almost all enterprises engaged in international trade encounter the risk of price fluctuations. Our findings indicate that larger corporations manage unforeseen circumstances more effectively than their smaller counterparts. Consequently, we endeavored to delineate the measures a corporation could implement to mitigate its exposure to currency fluctuations. The paper aimed to evaluate and delineate the present state of foreign currency operations at two medium-sized Swedish enterprises. Subsequently, recommendations were provided regarding how these groups may optimize the utilization of their available tools and resources. We established four primary subjects of paper and formulated four assumptions as the basis for our dissertation. We performed semi-structured interviews with two medium-sized firms to gain a clearer grasp of the issue from their perspective.

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