CURRENCY DERIVATIVES: ANALYSIS, STRATEGIES, AND RISK MANAGEMENT IN GLOBAL FINANCIAL MARKETS

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ABSTRACT: Companies doing business internationally should always factor in the likelihood of a change in currency rates. Since exports are crucial to the success of many Swedish enterprises, hedging against currency fluctuations is crucial. Currency fluctuations can be difficult, but there are several tools at your disposal to help you weather the storm. The goal of this dissertation is to outline the steps a medium-sized company may take to decrease the effect of currency fluctuations on its bottom line. We will also assess the state of foreign exchange activities at two Swedish SMEs and talk about how they might make better use of the various approaches and tools. We interviewed two subject matter experts (SMEs) to get a deeper grasp of the problems. Results from the case study show that while being aware that foreign currency risk is a severe danger to their global operations, medium-sized enterprises are not taking the necessary precautions. Therefore, the necessity should originate from the outside, particularly the banking sector. Businesses must have a plan in place to handle the possibility of currency fluctuations. It is to the banks' financial advantage to meet this demand, as satisfied consumers are more likely to become repeat clients. This could lead to a mutually agreeable resolution.

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

1. INTRODUCTION

Management, the board of directors, and, ultimately, shareholders, must always weigh the risks and potential returns of any business decision. Risk management is not a new concept, despite its recent prominence in corporate finance theory. Management has always weighed the benefits and drawbacks of potential actions with regards to the firm, such as expanding, investing, and issuing debt or stock, long before the term "derivative" was ever used in financial circles. Most managerial decisions, especially those having to do with risk management, have an impact on the state of the company's finances, which may be seen in the financial statements. There has been a continuous effort by the financial community to have financial statements made public ever since the time of Graham and Dodd. The lack of transparency in the financial sector's use of risk management methods (and derivatives in particular) has frustrated industry experts. Most businesses, according to surveys of market practice, approach risk in a piecemeal method, which just increases the complexity. While some companies set their hedging ratios based at least in part on forecasts of future market scenarios, others carefully manage foreign currency, interest rate, and commodity price risk with an eye on cash flows and the timing of investment outlays. Many companies evaluate the efficacy of risk management based solely on the performance of the derivative contracts, rather than considering the combined effect of the derivatives and the underlying risks. Even if the company labels this as "strategic hedging," it shows the inherent riskiness of using derivatives and should raise red flags with investors.

Problem Statement

Foreign exchange risk is a threat to businesses that conduct international business in a currency other than their own. Companies almost certainly have some sort of risk management strategy in place; the question is how effectively it is implemented. Large corporations typically have the resources (both human and material) to deal with crises like these. This threat is not unique to massive corporations, but rather increases in tandem with the significance of their foreign exchange operations. As a result, businesses of all sizes are vulnerable to fluctuations in the value of their currency. We have decided that they are not as skilled at dealing with it based on information from the literature and subject-matter specialists. We're curious as to how these businesses deal with currency fluctuations and how they employ customer relationship management software.

Purpose

The goal is to spell out measures that will lessen the impact of fluctuations in foreign exchange rates on the business. Foreign exchange activities at two Swedish SMEs will be evaluated, described in detail, and ideas for increasing their usage of various methods and instruments will be provided as a bonus.

2. LITERATURE REVIEW

The market for foreign exchange is by far the largest and has the highest volume of trading of any market in the world. Its daily transactions amount trillions of dollars, making it the undeniable leader in the market. This particular asset class is open to everyone, at any time of the day or night, five days a week; users can be as little as individual day traders or as large as multinational businesses. According to McFarlin (2010), the volume of daily trade on the market averages four trillion dollars. He elaborates by saying that people engage in foreign exchange trading because they want to profit from variations in exchange rates or because they want to decrease the risks that are associated with being exposed to a particular currency. He says that these goals motivate people to make trades in foreign currencies. He argues this for two reasons: first, so that he may make money off of the changes in exchange rates, and second, so that he can reduce the risks associated with being exposed to a certain currency. Spot markets, forward markets, futures markets, exchange-traded fund (ETF) markets, and options markets are the names given to the many marketplaces where currency trading takes place. According to research that was conducted out not too long ago and published not too long ago (Rosenberg, 2009), the spot market is where the vast majority of prices are established in today's market. This research was carried out not too long ago. Even in the present day, a substantial number of companies and investors only trade in a limited number of alternative currencies in compared to the dollar. Because of this, traders are only able to focus on the fundamentals of the dollar, which frequently results in a loss for them when compared to the fundamentals of the other side. According to Chelkowski (2010), it is possible to create a larger profit from trading cross pairs if the vehicle currency that is utilized is the United States dollar. This is because the dollar is the most liquid and most widely traded currency in the world. This is due to the fact that the United States Dollar is the most liquid of all the major currencies. According to the findings presented in the book Corporate Financial Management written by Glen Arnold and his co-authors, the vast majority of the transactions that take place on the Foreign Exchange market are carried out between banks for the purpose of speculating on future exchange rates rather than for the purpose of the underlying exporting or importing of goods or services. This information can be found in the aforementioned book. According to findings from a study that was carried out and made public by Ramcharran in the year 2000, there is a connection between the trading revenues of banks and the volatility of the currency markets. This offers much more evidence in support of the assertion.

3. METHODOLOGY

As was indicated at the very beginning of the piece, the objective of this piece is to provide an overview of the many different techniques that a firm can take in order to avoid the risks that are connected with trading in foreign currency. In addition to this, we wanted to analyze and describe the present foreign exchange operations that are taking place in two Swedish mid-corps, as well as provide some views for how the utilization of the various approaches and instruments may be improved. This was done in the hopes that it will be useful to other parties. In addition to the fact that we desired to investigate and describe the activities that are taking place at the present time, this was one of our goals. During the early stages of the process of writing the dissertation, my colleagues and I came to the realization that a significant number of medium-sized businesses do not effectively manage the foreign exchange risk that they face. This was one of the most important points that we made during the debate. As a direct result of this, we started off by receiving an overview of the information that had been made available in the past with the objective of acquiring foundational knowledge. The foreign currency market, the reasons that affect exchange rates, the concept of foreign exchange risk, the tools that are available for controlling exposure to foreign exchange, and the role that Swedish banks play within the theoretical framework have all been topics that we have studied.

Research Approach

When conducting an inquiry, one has the choice of employing either the deductive method or the inductive method. Both are valid approaches. According to Saunders et al. (2007), researchers are free to adopt either of these two approaches while carrying out their investigations. The data that was investigated is used to put into action the plan that was decided upon in order to arrive to the scientific conclusions that may be drawn from the data. The deductive method requires establishing concepts and hypotheses that already exist, in addition to designing a research strategy to examine these hypotheses. This is done as part of the overall process of "deducing" something from existing information. The inductive method is another name for this approach to research. When employing an inductive method, one first gathers data, and then, in order to construct a theory regarding the phenomenon that is being examined, one analyses that information. In addition, Saunders et al. (2007) claim that it is possible to combine inductive and deductive streams of reasoning in a single argument.

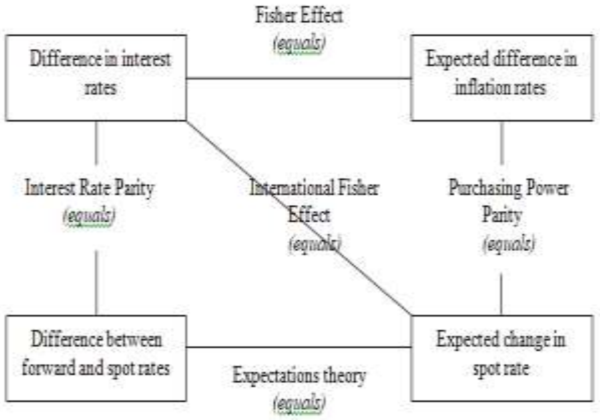

Figure 1: illustrates the four-way equivalence that exists within the market for foreign exchange.

Data

It is feasible to divide data into secondary data and significant data. The term "secondary data" refers to information that has previously been produced for another purpose and is not consequently regarded as "primary data." According to Christensen et al. (2001), the definition of primary data is information that is gained expressly for the purpose of the research project that is currently being carried out. In other words, primary data is information that has been gathered for the purpose of the research study. Secondary data, primary data, and the methodology all come together to form the core foundation, which provides us with essential information that is pertinent to the hypotheses and the research questions. This essential foundation also gives us access to the information that we require in order to carry out the research.

Primary Data

Depending on one's particular interests and needs, one has the option of collecting and analyzing primary data that is either quantitative or qualitative. Quantitative data are any data that may be represented numerically or that have been quantified. Quantitative data can also refer to data that have been quantified. In some contexts, the term "quantitative data" can also refer to data that has been quantified. It is often presented in the form of tables or diagrams in order to make it simpler to examine the statistical relationships that exist between the various variables. The purpose of providing this information in this format is to facilitate this comparison. This is done with the intention of making this comparison easier to understand. The term "qualitative data" will be used to refer to any data that is not numeric or that has not been quantified within the context of this conversation. To put it another way, quantitative measurements are not included in qualitative data. Words, texts, symbols, and actions are all components that go into the production of qualitative research, with the major emphasis being put on the meaning that lies behind the surface of the information that was acquired. In other words, qualitative research focuses on the meaning that lies under the surface of the information gathered. According to Christensen et al. (2001), it is more necessary to focus on the overall knowledge of the problem while conducting qualitative research. This is because it is more important to focus on the overall knowledge of the problem than it is to focus on the specific components that make up the problem.

As a result of the fact that we wanted to get an overall comprehension of the matter as well as an explanation of the current situation of the companies that were significant to us, we chose to conduct our inquiry using a qualitative methodology. In order to get primary data, we came to the conclusion that conducting interviews would be the most effective form of data collection for us to use. There are three distinct formats that can be utilized when conducting interviews: the unstructured, the semi-structured, and the structured formats are the three options. Structured interviews are conducted by making use of questions that have been prepared in advance and are standardized before the interview itself takes place. When conducting semi-structured interviews, the researcher will often come prepared with a list of topics and questions that need to be covered in order to fulfill their research objectives. On the other hand, the order in which the questions are asked might be switched up, and it's possible that I'll ask you for some additional questions. Interviews that do not conform to a predetermined structure are conducted in a less formal fashion than those that do. According to Saunders et al. (2007), they do not require any pre-prepared list of questions, and the respondent is given the choice to communicate freely about events, behavior, and views in relation to the subject matter. This is because the respondent is given the opportunity to discuss the subject matter in their own words.

Secondary Data

The first step in the process of gathering data involved us searching for secondary data. This stage is considered the beginning of the process. In order to get things rolling, we looked at previous research that had been conducted in the subject of CRM with the objective of locating uncharted territories. Finding new frontiers was the primary objective of our search. The method by which we gathered literature from a wide variety of publications that dealt with customer relationship management, the foreign exchange market, risk conceptualization, and other issues that were significant to this area of study was something that we maintained doing. Given that we were interested in acquiring essential knowledge, we viewed the fact that the customer relationship management (CRM) business is quite expansive as a benefit. This was due to the fact that one of our key goals was to gather pertinent information. In addition to this, it provided us with a solid foundation, which made it much simpler for us to compare and contrast the many various sources as well as the points of view expressed by the authors regarding the subject matter. On the other hand, we came to the insight that the authors of the books approached CRM in very similar ways. This was a very interesting discovery for us. Both of their points of view were highly similar to one another, in addition to the fact that they utilized the same conceptual frameworks and models. Because of this, obviously, the procedure of data collection has become a great deal less complicated as a result.

Authors whose works have been utilized by our company more frequently than those of other authors include instances such as Oxelheim and Shoup as well as Bennet and Buckley. This is due to the fact that they have been provided with more in-depth explanations of the concerns, which have, in turn, made it easier for them to comprehend the issues. They have been provided with more in-depth explanations of the issues, which is the basis for this turn of events.

We utilized the Internet in addition to the homepages of Swedish commercial banks in order to compile up-to-date information regarding the numerous strategies and tools that are at our disposal for mitigating the risk that is linked with currency exchange. Because of this, we were able to make more efficient use of the resources that were at our disposal. In addition to this, we have had in-depth conversations about the subject with a number of industry professionals, the most noteworthy of whom is Mats Ring of Swedbank Markets, who works in the field. Mats provided us with information regarding the operation of the various trading strategies when used in real-world circumstances, and he did it in a clear and concise manner. In addition, we called Nordea, SEB, and Handelsbanken in order to gain information regarding the steps that businesses can take when they are in need of information and support with CRM. Our goal in doing so was to get as much data as possible in this respect. Our objective was to have a deeper understanding of the various paths that businesses can pursue. On the other hand, it became difficult to obtain this information due to the fact that some of the workers working in the banks were unaware of the course of action that the companies should pursue in regards to this issue. This made it more difficult to obtain the information. In addition to this, we were interested in gathering some information regarding the degree to which businesses in Sweden make use of customer relationship management systems. In order to collect this information, we contacted a variety of institutions in Sweden, including the Bank of Sweden, commercial banks, and export banks, as well as other financial and statistical agencies in the country. On the other hand, given that there are no data that are relevant to this industry, nobody has been able to supply us with the information that we require. The theoretical framework that we are currently working inside is illustrated through the usage of the secondary data. In addition, without the assistance that the secondary data offered, we never would have been able to obtain the primary data.

4. FOREIGN EXCHANGE MARKET

As a result of globalization, both of these businesses have had to change to survive in today's economy. Companies can also be affected by swings in the foreign exchange market. While everyone involved in the foreign exchange market serves their own interests, their cooperation is essential to the market's success. Both businesses rely heavily on the foreign exchange market to conduct their daily business and international trade. The spot market and the forward market are two subsets of the larger foreign exchange market. The spot market is where currencies are traded in exchange for immediate delivery, whereas the forward market is for trading currencies with a future delivery date. X and Y are either present or former participants in the futures and spot markets. Companies X and Y participate in the spot market when they receive payments in a foreign currency, but in the forward market when they buy or acquire financial instruments.

Foreign currency market conditions are dynamic and ever-evolving. Since the introduction of the Euro (EUR), both of these institutions have traded fewer currencies, which has had a favorable effect on the market. The introduction of the Euro has also increased the selection of potential currencies for individual nations. Both X and Y Corporation have taken note of the new flexibility in choosing between the Euro and the Dollar when doing business in China.

Determination of Exchange Rates

The varying exchange rates of currencies around the world are the consequence of a complex interplay between a number of different elements. In the theoretical part, we discussed the components of a model. Short- and long-term relationships between interest rates, inflation, and currency exchange rates are modeled. Each of these factors will affect the value of the dollar around the world, which in turn will have an effect on Companies X and Y. Although it would improve performance in the long run, companies X and Y do not take into account the relationship between the components in their day-to-day operations.

Foreign Exchange Risk

Unfortunately, this is a lesson that both Company X and Company Y had to learn the hard way. Company X's disclosure of risks was more general than that of Company Y. Both Company X and Company Y are vulnerable to a wide variety of hazards. The risks that a firm faces will appear different depending on whether it conducts business domestically or abroad.

RISKS IN INTERNATIONAL BUSINESS

Commercial Risk

When both parties do what they're supposed to, there is no commercial risk in the deal. Such obligations may involve, for instance, the buyer's financial resources or the seller's distribution network. Both Company X and Company Y are vulnerable to this risk as a result of their combined commercial activity. In a global context, it may be more challenging to handle the commercial risks that come with conducting business abroad. This occurs at Company Y when orders from overseas are returned as unsatisfactory. Because of the high expense of delivery, the company takes precautions to limit product returns wherever possible. Both firms' foreign operations expose them to significant commercial risk. Company X, for instance, addressed this risk through the use of documented letters of credit, whereas Company Y did not mention whether or not it did so.

Financial Risk

Companies X and Y have such varied financial situations because they participate in such different economic activities. Since company X values timely payments highly, it is common practice for the company to mortgage its bills in order to raise cash. When compared to Company X, which has more stable cash on hand, Company Y is in far worse financial shape due to its reliance on short-term loans. This is due to the fact that the corporation has no idea when or how much money will be paid out. Company Y now gives consideration to the amount of interest displayed. Neither doing business locally nor internationally is immune to the financial risk, nor is it immune to the commercial risk. However, international financial risk will be distinctive and harder to manage.

5. CONCLUSION

Sweden's domestic market is small and rising slowly, so Swedish companies now focus much more on exports than in the past. Because of globalization, Swedish companies can now fight in markets where they couldn't before. Even though the promise of new chances is exciting, it's important to be aware of the risks that may come with them. One of these factors is how often foreign exchange rates change. There are numerous methods for handling foreign exchange risk. Almost every business that trades internationally has some risk of price fluctuations. We found that bigger companies are better able to handle unexpected events than their smaller counterparts. So, we set out to explain the steps a company can take to limit its risk from changes in currency. The goal of this study was to look at and describe the current state of foreign exchange activities at two Swedish mid-sized businesses. Then, suggestions were made for how these businesses could make the most of the tools and resources they had. For our dissertation study, we came up with four main hypotheses and areas of inquiry. We did semi-structured interviews at two medium-sized businesses to find out what the problem was like from the companies' points of view.

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