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Postgraduate Certificate in International Finance

# Foreign Exchange and Currency Risk

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## Foreign Exchange and Currency Risk

Foreign exchange and currency risk are crucial concepts in international finance, especially for businesses operating in multiple countries. Below is a detailed glossary of terms related to foreign exchange and currency risk in the context of the Postgraduate Certificate in International Finance:

### 1. Foreign Exchange (Forex)

Foreign exchange, also known as forex, refers to the global marketplace for buying and selling currencies. It is where currencies are traded against each other, determining their relative value. Forex markets operate 24 hours a day, five days a week, allowing participants to engage in currency trading at any time.

### 2. Currency Exchange Rate

The currency exchange rate is the price of one currency in terms of another. It indicates how much of one currency is needed to purchase a unit of another currency. Exchange rates fluctuate constantly due to various factors such as economic indicators, geopolitical events, and market sentiment.

### 3. Spot Exchange Rate

The spot exchange rate is the current market rate at which currencies can be exchanged for immediate delivery. It reflects the real-time value of one currency relative to another and is used for transactions that require immediate settlement.

### 4. Forward Exchange Rate

The forward exchange rate is the rate at which currencies can be exchanged at a specified future date. It allows businesses to lock in a specific exchange rate for a future transaction, providing protection against currency fluctuations.

### 5. Currency Appreciation

Currency appreciation occurs when a currency increases in value relative to another currency. It can be the result of factors such as strong economic performance, high interest rates, or political stability. Currency appreciation makes imports cheaper and exports more expensive.

### 6. Currency Depreciation

Currency depreciation refers to a decrease in the value of a currency relative to another currency. It can be caused by factors like economic downturns, low interest rates, or political instability. Currency depreciation makes exports cheaper and imports more expensive.

### 7. Cross Currency Exchange Rate

A cross currency exchange rate is the rate at which two currencies are exchanged without involving the US dollar. It allows direct conversion between two non-USD currencies and is commonly used in international transactions involving currencies other than the US dollar.

#### 8. Currency Hedging

Currency hedging involves using financial instruments to mitigate the risks associated with currency fluctuations. It allows businesses to protect themselves against potential losses due to adverse movements in exchange rates. Currency hedging strategies include forward contracts, options, and futures.

#### 9. Currency Risk

Currency risk, also known as exchange rate risk, is the risk that changes in exchange rates will impact the value of financial transactions denominated in foreign currencies. It affects businesses engaged in international trade, investments, or financing and can lead to financial losses if not managed effectively.

#### 10. Transaction Exposure

Transaction exposure is a type of currency risk that arises from the impact of exchange rate fluctuations on specific transactions denominated in foreign currencies. It affects the value of imports, exports, or foreign currency-denominated payments or receipts.

#### 11. Translation Exposure

Translation exposure, also known as accounting exposure, is the risk that changes in exchange rates will affect the value of a company's financial statements when they are translated into the reporting currency. It arises from the consolidation of foreign subsidiaries' financial statements.

#### 12. Economic Exposure

Economic exposure, also known as operating exposure, is the risk that changes in exchange rates will impact a company's future cash flows and profitability. It arises from the competitive position of a company in response to exchange rate fluctuations affecting sales, costs, and market share.

#### 13. Currency Swaps

Currency swaps are agreements between two parties to exchange principal and interest payments denominated in different currencies. They allow participants to manage currency risk by converting cash flows from one currency to another at predetermined exchange rates.

#### 14. Cross Currency Swaps

Cross currency swaps are a type of currency swap where the exchanged currencies are different from each other. They are used to hedge currency risk or obtain financing in a currency different from the one in which the cash flows are denominated.

#### 15. Currency Options

Currency options are financial derivatives that give the holder the right, but not the obligation, to buy or sell a specific amount of a currency at a predetermined exchange rate within a specified time frame. They provide flexibility in managing currency risk.

#### 16. Currency Futures

Currency futures are standardized contracts traded on exchanges that obligate the parties to buy or sell a specified amount of a currency at a predetermined price and date in the future. They are used for hedging or speculation in the foreign exchange market.

### 17. Currency Speculation

Currency speculation involves betting on the future direction of exchange rates to make a profit. Speculators buy or sell currencies based on their expectations of how exchange rates will move, taking advantage of fluctuations in the forex market.

### 18. Carry Trade

A carry trade is a strategy where investors borrow funds in a low-interest-rate currency and invest them in a higher-yielding currency to profit from the interest rate differential. Carry trades are exposed to currency risk but can generate returns if exchange rates remain stable.

### 19. Currency Peg

A currency peg is a fixed exchange rate regime where a country's currency is tied to another currency or a basket of currencies. The pegged currency's value is maintained within a narrow band by the central bank through interventions in the foreign exchange market.

### 20. Currency Board

A currency board is a monetary system where a country's currency is pegged to a foreign currency at a fixed exchange rate, and the central bank holds reserves in the anchor currency to back the local currency. Currency boards are designed to maintain exchange rate stability.

### 21. Managed Float

A managed float is an exchange rate regime where the value of a country's currency is determined by market forces but with occasional interventions by the central bank to influence the exchange rate. It allows for some flexibility in the exchange rate while preventing excessive volatility.

### 22. Exchange Rate Pass-Through

Exchange rate pass-through is the extent to which changes in exchange rates are reflected in the prices of imported goods and services. It measures how much of a currency depreciation or appreciation is passed on to consumers through higher or lower prices.

### 23. Exchange Rate Regime

An exchange rate regime is the framework adopted by a country to determine how its currency's value is determined in relation to other currencies. Common exchange rate regimes include fixed exchange rates, floating exchange rates, pegged exchange rates, and managed floats.

### 24. Dollarization

Dollarization is the adoption of a foreign currency, typically the US dollar, as the official currency of a country alongside or instead of the domestic currency. Dollarization can help stabilize the economy and reduce currency risk but may limit the central bank's ability to conduct monetary policy.

### 25. Eurocurrency Market

The Eurocurrency market is a global market where banks and corporations outside the Eurozone hold and lend euro-denominated deposits. Eurocurrency deposits are often used for international trade and finance transactions, allowing participants to avoid currency restrictions and regulations.

#### 26. International Monetary System

The international monetary system is the set of rules, institutions, and agreements that govern international financial transactions, exchange rates, and monetary policy coordination among countries. It includes organizations like the IMF, World Bank, and international agreements like the Bretton Woods system.

#### 27. Bretton Woods Agreement

The Bretton Woods Agreement was a landmark international agreement signed in 1944 that established the post-World War II monetary system. It created the IMF, World Bank, and fixed exchange rate regime with the US dollar as the anchor currency pegged to gold.

#### 28. International Monetary Fund (IMF)

The International Monetary Fund (IMF) is an international financial institution established to promote global monetary cooperation, exchange rate stability, and economic growth. It provides financial assistance, policy advice, and technical assistance to member countries facing balance of payments problems.

#### 29. World Bank

The World Bank is an international financial institution that provides loans and grants to developing countries for projects aimed at reducing poverty and promoting sustainable development. It consists of two institutions: the International Bank for Reconstruction and Development (IBRD) and the International Development Association (IDA).

#### 30. Special Drawing Rights (SDRs)

Special Drawing Rights (SDRs) are an international reserve asset created by the IMF to supplement member countries' official reserves. SDRs are allocated to IMF members based on their quotas and can be used to settle international transactions, diversify reserves, or provide liquidity in times of crisis.

#### 31. Balance of Payments (BOP)

The balance of payments is a systematic record of a country's economic transactions with the rest of the world over a specific period. It consists of the current account, capital account, and financial account, reflecting the country's trade, investment, and financial flows with other countries.

#### 32. Current Account

The current account is a component of the balance of payments that records a country's trade in goods and services, as well as income receipts and payments from abroad. It reflects the net export or import of goods and services and the net income earned from foreign investments.

#### 33. Capital Account

The capital account is a component of the balance of payments that records a country's cross-border transactions in financial assets and liabilities. It includes foreign direct investment, portfolio investment, and other capital flows that affect a country's external wealth and financial position.

#### 34. Financial Account

The financial account is a component of the balance of payments that records a country's cross-border transactions in financial assets and liabilities. It includes purchases and sales of foreign securities, changes in reserve assets, and other financial flows that impact a country's external balance.

### 35. Exchange Controls

Exchange controls are government regulations that restrict or regulate the buying, selling, and holding of foreign currencies by residents and businesses. They are used to manage capital flows, stabilize exchange rates, and prevent currency speculation in times of economic instability.

### 36. Capital Controls

Capital controls are government measures that restrict the flow of capital in and out of a country to safeguard its financial stability. Capital controls can include limits on foreign investment, restrictions on transferring funds abroad, or requirements for approval to engage in certain financial transactions.

### 37. Convertibility

Convertibility refers to the ability of a currency to be freely exchanged for other currencies or assets without restrictions. Convertibility can be full, allowing unrestricted exchange, or partial, with limitations on currency transactions imposed by the government.

### 38. Offshore Financial Center

An offshore financial center is a jurisdiction that offers financial services to non-residents in a low-tax or lightly regulated environment. Offshore financial centers attract foreign investments, facilitate international trade, and provide financial privacy and confidentiality to clients.

### 39. Sovereign Wealth Fund

A sovereign wealth fund is a state-owned investment fund that manages a country's foreign exchange reserves and invests in financial assets globally. Sovereign wealth funds are typically created to preserve and grow a country's wealth for future generations or strategic purposes.

### 40. Currency Crisis

A currency crisis is a sudden and sharp decline in the value of a country's currency, leading to financial instability, capital flight, and economic turmoil. Currency crises can be triggered by factors like speculative attacks, macroeconomic imbalances, or political unrest.

### 41. Balance of Trade

The balance of trade is a component of the current account that measures the difference between a country's exports and imports of goods. A positive balance of trade (surplus) occurs when exports exceed imports, while a negative balance of trade (deficit) occurs when imports exceed exports.

### 42. Hedged Transaction

A hedged transaction is a financial transaction that is protected against currency risk using hedging strategies like forward contracts, options, or swaps. By hedging the exchange rate exposure, businesses can reduce the impact of currency fluctuations on the transaction's value.

### 43. Unhedged Transaction

An unhedged transaction is a financial transaction that is exposed to currency risk without any protection against exchange rate fluctuations. Unhedged transactions can lead to gains or losses depending on how exchange rates move between the transaction initiation and settlement dates.

#### 44. Arbitrage

Arbitrage is the practice of exploiting price differences in financial markets to make a profit with little or no risk. In currency markets, arbitrage involves buying and selling currencies simultaneously in different markets to take advantage of inefficiencies in exchange rates.

#### 45. Triangular Arbitrage

Triangular arbitrage is a complex trading strategy that involves exploiting price discrepancies between three different currencies to make a profit. Traders conduct a series of simultaneous transactions to capitalize on the mispricing of exchange rates in the foreign exchange market.

#### 46. Covered Interest Rate Parity

Covered interest rate parity is a theoretical concept that suggests the interest rate differential between two currencies should be equal to the forward exchange rate premium or discount. If covered interest rate parity holds, it implies that there are no arbitrage opportunities in the forex market.

#### 47. Uncovered Interest Rate Parity

Uncovered interest rate parity is a theoretical concept that suggests the expected return on investing in two different currencies should be equal when adjusted for exchange rate changes. If uncovered interest rate parity holds, it implies that investors are indifferent between holding domestic or foreign assets.

#### 48. Fisher Effect

The Fisher effect is an economic theory that posits a direct relationship between nominal interest rates, real interest rates, and expected inflation. According to the Fisher effect, nominal interest rates adjust to reflect changes in expected inflation, maintaining real interest rates at a constant level.

#### 49. Purchasing Power Parity (PPP)

Purchasing power parity is an economic theory that suggests exchange rates should adjust to equalize the prices of identical goods and services in different countries. PPP is used to compare the relative value of currencies and determine whether a currency is overvalued or undervalued.

#### 50. Law of One Price

The law of one price is an economic principle that states identical goods should have the same price when expressed in a common currency. If the law of one price holds, arbitrage opportunities will be eliminated as traders buy goods in low-priced markets and sell them in high-priced markets.

#### 51. Big Mac Index

The Big Mac Index is an informal measure of purchasing power parity created by The Economist magazine. It compares the prices of a Big Mac hamburger in different countries to determine whether currencies are overvalued or undervalued based on the theory of purchasing power parity.

#### 52. Real Effective Exchange Rate (REER)

The real effective exchange rate is a measure of a country's currency value adjusted for inflation and trade-weighted against a basket of foreign currencies. REER reflects the relative competitiveness of a country's exports and imports and is used to assess exchange rate misalignments.

### 53. Nominal Effective Exchange Rate (NEER)

The nominal effective exchange rate is a measure of a country's currency value against a basket of foreign currencies based on nominal exchange rates. NEER reflects the relative strength or weakness of a currency compared to its trading partners and is used to monitor exchange rate movements.

### 54. Exchange Rate Forecasting

Exchange rate forecasting is the process of predicting future movements in exchange rates based on economic indicators, technical analysis, and market trends. Forecasting exchange rates is essential for businesses and investors to make informed decisions and manage currency risk effectively.

### 55. Random Walk Hypothesis

The random walk hypothesis is an economic theory that suggests future changes in asset prices, including exchange rates, cannot be predicted based on past price movements. According to the random walk hypothesis, asset prices follow a random pattern and are not influenced by historical data.

### 56. Volatility Risk

Volatility risk is the risk that exchange rates will experience sharp and unpredictable fluctuations, leading to increased uncertainty and potential losses for businesses and investors. Volatility risk is influenced by factors like economic events, geopolitical developments, and market sentiment.

### 57. Liquidity Risk

Liquidity risk is the risk that arises from the inability to buy or sell currencies quickly and at a fair price in the market. Illiquid markets can expose participants to liquidity risk, making it challenging to execute transactions or unwind positions without significant price impact.

### 58. Counterparty Risk

Counterparty risk is the risk that the other party in a financial transaction will fail to fulfill its obligations, leading to potential losses for the counterparties involved. In foreign exchange transactions, counterparty risk can arise from defaults, bankruptcies, or operational failures of financial institutions.

### 59. Settlement Risk

Settlement risk is the risk that one party in a foreign exchange transaction will deliver the currency or securities while the other party fails to fulfill its obligations, resulting in a settlement failure. Settlement risk can lead to financial losses and disruptions in the financial system.

### 60. Systemic Risk

Systemic risk is the risk of widespread financial instability or market disruptions that can affect the entire financial system. In the context of foreign exchange and currency risk, systemic risk can arise from interconnectedness, contagion, or structural vulnerabilities in the global financial markets.

### 61. Black Swan Event

A black swan event is a rare and unpredictable occurrence with severe consequences that disrupt financial markets and defy conventional forecasting methods. Black swan events can have a significant impact on exchange rates, causing sudden and extreme movements in currency values.

#### 62. Tail Risk

Tail risk is the risk of extreme and unexpected events that fall outside the normal distribution of outcomes. In foreign exchange markets, tail risk refers to the possibility of large and sudden movements in exchange rates that can lead to substantial losses for market participants.

#### 63. Stress Testing

Stress testing is a risk management technique that assesses the resilience of financial institutions and portfolios to adverse market conditions or extreme scenarios. In the context of foreign exchange and currency risk, stress testing helps identify vulnerabilities and weaknesses in currency risk management strategies.

#### 64. Value at Risk (VaR)

Value at Risk is a statistical measure used to quantify the potential loss in the value of a portfolio or investment over a specific time horizon at a given confidence level. VaR is a popular risk management tool for assessing and controlling market risk, including currency risk.

#### 65. Scenario Analysis

Scenario analysis is a risk management technique that evaluates the impact of different potential scenarios on a portfolio or business. In the context of foreign exchange and currency risk, scenario analysis helps assess the sensitivity of assets and liabilities to changes in exchange rates.

#### 66. Sensitivity Analysis

Sensitivity analysis is a risk management technique that measures how changes in input variables, such as exchange rates, affect the output of a financial model or investment decision. By conducting sensitivity analysis, businesses can identify key risk factors and their impact on financial performance.

#### 67. Risk Management Framework

A risk management framework is a structured approach that defines the processes, policies, and tools used