CNY & USD: Foreign Exchange Rates

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A forward rate is related to a spot rate that is set to take place in the future (Bekaert & Hodrick, 2012). Interestingly, one issue that can be challenging when performing transactions is not knowing what the rate will yield in the future versus at present. Due to market pressures or even policy decisions, either a devaluation or revaluation of domestic currency to foreign currencies can transpire. In terms of foreign exchange rate risk, countries tend to choose different exchange rates methods that can result in the risk of loss due to fluctuations in exchange rates and the ability to manage risks that can happen to countries (Bekaert & Hodrick, 2012). For example, an asset in one country may lose value because of the exchange rate fluctuations in another country. This paper will observe both the United States and China's forward and spot rates by computing an example and the implications for risk management among the currencies.

**Relationship Between Forward & Spot Rates**

Using an example, the exchange rate on November 4th was 1 CNY = equals 0.157734 USD (XE Currency Converter, 2015). Due to many factors, exchange rates fluctuates on a daily basis. Therefore, below is an explanation of forward rate relationship using the American dollar and the Chinese Yuan.

\[
10Y \text{ is equal to } 1.57734
\]

\[
100Y \text{ is equal to } 15.7734
\]

**My original calculation yielded:**

An example to calculate the six-month forward premium for the dollar versus the Yuan deliverable in 90 days. Given a spot rate quote of 17.09 Yuan and a six-month forward rate of 16.67 using the formula below.
Forward- Spot x (360/n days) x 100 = Spot

\[
\begin{align*}
16.67 - 17.09 \times (360/90) \times 100 &= 17.09 \\
-0.42 \times 4 \times 100 &= 17.09 \\
-.0246 \times 4 \times 100 &= -9.84
\end{align*}
\]

From my calculation, -.0984 is negative, so we can determine that the Yuan is trading at 9.84% discount against the Dollar for delivery in 90 days while the Dollar is trading at a premium against the Yuan. I used the value of 100Y to equal 15.77 in 90 days the value of 100Y will equal to 16.67 at a forward rate. I made up the value of 100Y equals to 17.09 as a spot value. So the comparison is built on the value of 100Y against the equal value of the dollar. However, as explained in the discussion, that should have been the dollar value, not the Yuan as being negative.

From the assigned reading, it is noted that forward rates or perhaps the future spot exchange rate are uncertain; however, exchange rates can move in either direction which can create a loss regardless of thoughts of manipulation. In 2005, China revalued the Yuan by 2.1 percent to Yuan 8.11/USD and announced that it would switch from the dollar peg to a basket peg, and would allow for more flexible floating of the currency (Soofi, 2009). However, since then, economic problems have arisen which have caused dramatic short-term fluctuations in currency values. Helpful in risk management, financial markets have several methods that are used to hedge the risks of exchange rates fluctuations reducing implications in many cases while assisting in appropriate decision making.
Regarding spot and forward markets, it is viewed as a precondition for adopting a more flexible exchange rate regime. For instance, a well-developed currency market is necessary for Chinese banks and businesses to hedge against foreign currency exposure. For well-known currency markets volatility, absent the forward and swap markets, the banks, and businesses would be exposed to unacceptable currency risks, some Chinese experts believe (Soofi, 2009). It is clear that Chinese and Americans have a different view when it comes to full-fledged floating exchange rate system.

Implications for Risk Management

In terms of the foreign exchange risk factors for the American Dollar and the Chinese Yuan, it is important to know that exchange rates fluctuate from day to day. Therefore, understanding how rates may fluctuate provides an understanding of foreign exchange risk. Failure to properly address the operational risks of foreign exchange rate fluctuations can have serious implications; therefore, management of risk is imperative to corporations. For example, mismanagement can reduce corporate profit and even lead to operational losses as a result of the difficulty to sustain business operations when experiencing sudden fluctuations in rates. For trading priced using the USD, depreciation of the CNY increases the cost of payments in CNY, and appreciation of the CNY decreases the profits receivable in USD; thus, both reduce corporate profit and even lead to operational losses (Huang, 2012).

According to Huang (2012), foreign exchange forward contracts or foreign exchange options can permit corporations to hedge exchange rate risks. However, the key part is not the instrument chosen; instead, it is the ability of corporations to foresee fluctuations in the exchange rate. By employing a tool that can predict exchange rates, corporations can retain their existing business profits and create exchange gains. Equally important when it comes to
managing risk, corporations must determine the type of current risk exposure which will allow them to choose a tool or instrument to deal with the risks. Managing the exchange rate risk by hedging strategy is found to be an efficient way to effectively decrease the exchange exposure. It provided many benefits including minimizing the effects of exchange rate movements, increasing the predictability of future cash flows and eliminating the need to accurately forecast the future direction of exchange rates (Hassanain, 2015).

Conclusion

As presented, a forward rate is related to a spot rate that is set to take place in the future (Bekaert & Hodrick, 2012). Interestingly, one issue that can be challenging when performing transactions is not knowing what the rate will yield in the future versus at present. In terms, of foreign exchange rate risk, countries tend to choose different exchange rates methods that can result in the risk of loss due to fluctuations in exchange rates and the ability to manage risks that can happen to countries (Bekaert & Hodrick, 2012). However, understanding how rates may fluctuate provides an understanding of foreign exchange risk and what is required to manage the implication of risk.
Reference


