Task: If the US dollar were to appreciate substantially, what steps could a domestic manufacturer take in advance to reduce the effect of the exchange rate fluctuation on company profitability?

Answer:

The risk that a business' operations or an investment's value will be affected by changes in exchange rates is known as exchange rate risk.

Defensive methods against the exchange rate risk are:

- to reduce the risk by using one of the forms of hedging available through a bank:
  - to arrange a forward foreign exchange contract;
  - to open a foreign currency account - a bank account operated in the United States in a foreign currency of manufacturer`s choice;
  - to open a bank account in the country with which the manufacturer is trading (this option suits businesses that make or receive lots of payments - especially small payments - in a foreign currency);
- to trade overseas in local currency, effectively transferring the foreign exchange risk to the business the manufacturer is dealing with;
- flexible forward transactions, which have the same characteristics as a forward transaction with only one specific difference, which is that the settlement of the transaction can take place at any time until the maturity of the contract;
- to arrange an option contract (FX Option), which give their buyer the right but not the obligation to sell/buy a specific amount at a pre-agreed exchange rate;
- a currency swap transaction, which represent an agreement to exchange one currency for another at an agreed upon exchange rate. There are two simultaneous transactions, one of buying and one of selling the same amount at two different value dates (usually SPOT and FORWARD) and at exchange rates (SPOT and FORWARD) that are pre-agreed at the moment when the transaction is closed;
- to price the sale in a foreign currency in exchange for cash in advance.

In choosing between these different financial techniques the firm should consider the costs and the ultimate home currency cash flows (appropriately adjusted for time value) of each method based upon the prices available to the firm. The different techniques involve different types of cash flows at different points in time and this must also be taken into account by the firm.