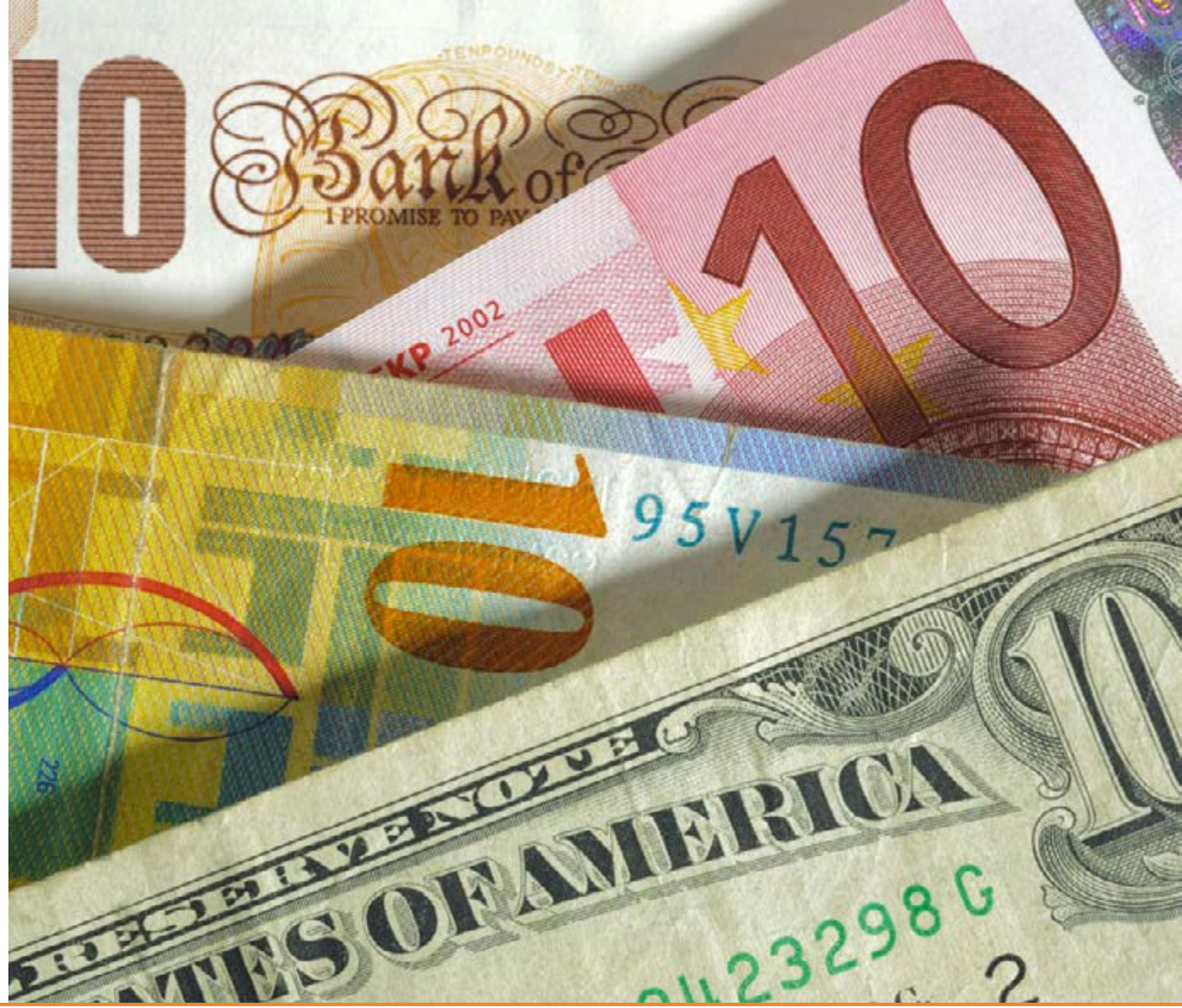
The definitive guide to foreign exchange

A guide for global businesses

Don’t pay regular foreign exchange rates

When you’re doing business internationally, importing or selling materials, or paying offshore contractors, you’ll always come up against a largely ignored part of operating costs: **foreign exchange rates**. If you’ve been doing this for a while, you know that exchanging your cash into another country’s currency is reason to cringe or cheer, depending on the day, and where your money is going.

The mechanics of exchange rates are a mystery to c-level executives and hardened professionals, let alone the uninitiated. Knowing the ins and outs of why rates change will keep you informed, help you plan for the future, and improve your cash flow, saving your business money on global transfers.



What are exchange rates?

A foreign exchange rate (also called a **forex** rate) is how much of one currency you can trade for another, or the cost of a particular currency in the context of another. It can be a bit confusing to define, as you're basically determining the price of money by using, well, money. It's like when you look up a word in the dictionary, and the definition uses the word to help define it. Super annoying, very confusing.

Each country or group of countries has its own accepted system of money. The United States and its territories (among other countries such as Ecuador) use the US dollar, members of the European Union use the Euro, and Japan has the Yen, but that doesn't even scratch the surface.

There are 180 "circulating" currencies among UN Member States, meaning they are currently in use, and are used, in various capacities, in the global economy. Some countries even use multiple currencies, making things even more confusing. For example, the United Kingdom's many islands and territories, such as Jersey and Alderney, recognize the British pound as well as their own regional currencies, the Alderney, Guernsey, and Jersey pound. But, they have nothing on Zimbabwe, which boasts **nine** nationally recognized currencies including the US dollar, Zombabwean bonds, Euro, and Indian rupee.

Just like with a product or service, currency is a commodity which is bought and sold. In order to trade or make purchases in another country, you need to first buy that country's money with your own country's money. When we talk about exchange rates, we're always comparing the currencies of two countries against each other. Even if a country recognizes multiple currencies, one nation centralizes and is responsible for the value of each circulated currency.

So, how do you find out how much of one currency you can purchase? That's where foreign exchange rates come in.

For example, the exchange rate of the American dollar (USD) against the Canadian dollar will tell you how much of the American currency you need in order to purchase one Canadian dollar. If the exchange rate is 0.76, you'll need 76 American cents to buy one Canadian dollar. This means that the Canadian dollar is worth less than the American dollar. But if you convert USD to Euros, the exchange rate is around 1.12. This means that you'll need $1.12 USD to buy one Euro because the Euro is worth more than the American dollar.

Historically, some countries have tried to exponentially increase the value of their currency, causing hyperinflation. Basically, this causes the "real" value of the currency (what the rest of the world considers to be its value) to decrease. Prices of goods increase, and generally leads people to invest in more stable currencies such as the US dollar.

How are the rates and cost of currencies determined? Well, to some extent, it's a bit arbitrary. Essentially, a country can price out their currency anyway they want because, in many ways, currency values are a construct: they're made up. Well, until you go too far.

But, where did this all come from?

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A brief history of exchange rates

For the uninitiated, there are three different types of exchange rates:

- **Floating:** the value of currency changes based on supply and demand.
- **Fixed (also called pegged):** the government fixes the currency of the country to a stable commodity, to another currency, or to a group of currencies.
- **Hybrid:** the currency is pegged to a value that is periodically adjusted.

The earliest form of exchange was bartering, where goods were traded for other goods. This evolved into the use of precious metals for trading (mostly gold). In the 1800s and early 1900s, countries printed paper money that was fixed to the value of gold, which meant that the exchange rates between countries were also fixed. This system was referred to as the Gold Standard. More money could not be printed without increasing a country's gold reserve.

But, during WWI, European countries needed to temporarily abandon the gold standard to finance the war. But following the end of the war, European countries that had borrowed from the US were unable to repay their debts and started to abandon the gold standard for good. Once the Great Depression hit, the US also needed a new system to stimulate their economy.

In 1944, the Bretton Woods agreement replaced the gold standard with a fixed (or pegged) exchange rate. Countries fixed the value of their currencies to the US dollar, which was fixed to the value of gold at USD$35 per ounce because the US had the most gold in reserve. This system provided stability for the post-war economy, while also giving countries the freedom to adjust their currency within 1% of the USD. But the gold reserve would run short.

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The US set up the Marshall Plan in support of European countries devastated by the war to avoid protectionism. This foreign aid along with military spending caused inflation to rise. By the 1960s, the United States no longer had enough gold for the US dollars in circulation, and the Bretton Woods system collapsed. Nixon separated the value of the dollar from gold in 1971, and the USD became a free-floating currency (see what we meant by “arbitrary?’). Other countries could choose to let their currency float, fix their currency to another country, or fix their currency to a basket of currencies.

Now that we understand the concept of a “free-floating currency,” understanding why the rates change is the next logical step. So, here we go.

Choosing an exchange rate system

Each type of exchange rate has its own advantages and disadvantages. The question of which type is best depends on each country's history, stability, and economic goals.

Here are the three major exchange rate systems described with much more detail.

Floating

Floating exchange rates are not controlled by the government and change in relation to the currency of other countries. While this system is more volatile than a fixed rate, there's less management required on the part of the centralized banking system because the rate adjusts automatically based on supply and demand. A floating rate is a good option for:

- Countries with developed financial markets.
- Stable governments in a position to pursue their own monetary policies.
- Countries that want to insulate themselves from economic problems in other countries.
- Countries more confident in their own central bank than that of other countries.

Since the collapse of the Bretton Woods system, most developed economies have implemented a free-floating currency. Of course, with the strongest global currency, the US is a prime example. Canada also adopted a floating system from 1950 until 1962, then again from 1970 to the present-day.

As a former Governor of the Bank of Canada noted, "No other major country has had as much experience with a floating exchange rate." A floating rate allows Canada, and other countries using the same system, to respond to economic shocks that affect the country differently than the US and to control their own domestic economic policies, which outweighs the benefits of a fixed system in their case.

Fixed

Fixed (or pegged) rates are tied to a single currency or a group (called a basket) of currencies. The foreign currency selected is one that conducts a high volume of trade with the country. Fixed rates still change, but they fluctuate with the country they're pegged to, so trade is more stable. The government needs to buy and sell their own currency and adjust interest rates to make sure it remains at the same fixed rate. There are situations where it would benefit the country's economy if supply and demand controlled the exchange rate. While a floating rate gives the country the freedom to choose not to intervene, a fixed rate requires regular intervention. A fixed rate is a good option for:

- Smaller nations exporting the majority of their goods to one country.
- Developing economies that don't have a stable centralized bank.
- Nations with unstable governments or leadership.

Most countries that opt for this system peg their currency to USD, especially if a large portion of their revenue comes in US dollars. USD is the most widely traded currency and is also the currency most-used for trading commodities like oil and precious metals. Several countries outside of the United States have adopted the American dollar as their own currency, and many more keep their currency pegged to the USD. Many African countries that were once European colonies peg their currency to the Euro. In other countries, a currency might be pegged at different percentages to the USD, Euro, and British pound. Pegging to a range of currencies avoids the volatility of being tied to just one.

Pegged-float hybrid

A pegged float (or what can also be called a managed float) is a hybrid of the floating and fixed systems. The currency is fixed to another currency, but there is still room for fluctuation between established values. There are different types of pegged float systems, but in each case the currency will be periodically adjusted. A crawling peg is an example of this kind of hybrid that's implemented in Argentina and Egypt. The country benefits from pegging their currency to the USD, but their currency can also rise and fall in response to the foreign exchange market.

Why do exchange rates change?

Because an exchange rate compares two currencies, the rise in value of one means the fall of the other. It costs $1.30 Canadian to buy 1 USD, but only 76 American cents to buy one Canadian dollar. If the demand for the American dollar increased, Canadians might now need to pay $1.40 for one USD. If American currency has risen in value, the USD can now buy more of the Canadian currency, so it would cost less than 76 cents to buy one Canadian dollar.

You might have heard the term “strong dollar” used in the news or in conversations around investment. Each currency can be described as strong or weak when being compared with another currency. A strong US dollar means the foreign currency being compared to it is weaker. When the US dollar is strengthening, it can buy more of a foreign currency. But don’t assume a strong currency is always a good thing. It’s good for imports because the American currency can purchase more from another country. But a weakening currency is good for exports because the price of that country’s goods will be cheaper for other countries, meaning they’ll be more in demand.

The exchange rates of less stable countries might change dramatically from day to day. Countries with more stable economies and strong exports don’t fluctuate as much, but small changes still have a big impact.

What makes the value of a currency rise and fall? It's all about supply and demand. A high demand for a currency or a shortage in supply increases its value. This value is determined by imports and exports. The demand for a currency is determined by the demand for exports from a particular country. The supply of a currency is determined by looking at the demand for imports from abroad.

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For example, the Canadian dollar has been consistently worth less than the American dollar. But it's important to know how much less when you're sending money across borders. A relatively stable exchange rate like the one between CAD/USD rate will still fluctuate from day to day, especially if there are economic or political events making the news. Those fluctuations can make a big difference for your business, meaning that the times you choose to buy and sell a foreign currency are very important. Keep an eye on the mid market rate, and the rate your payments provider is offering.

What affects exchange rates?

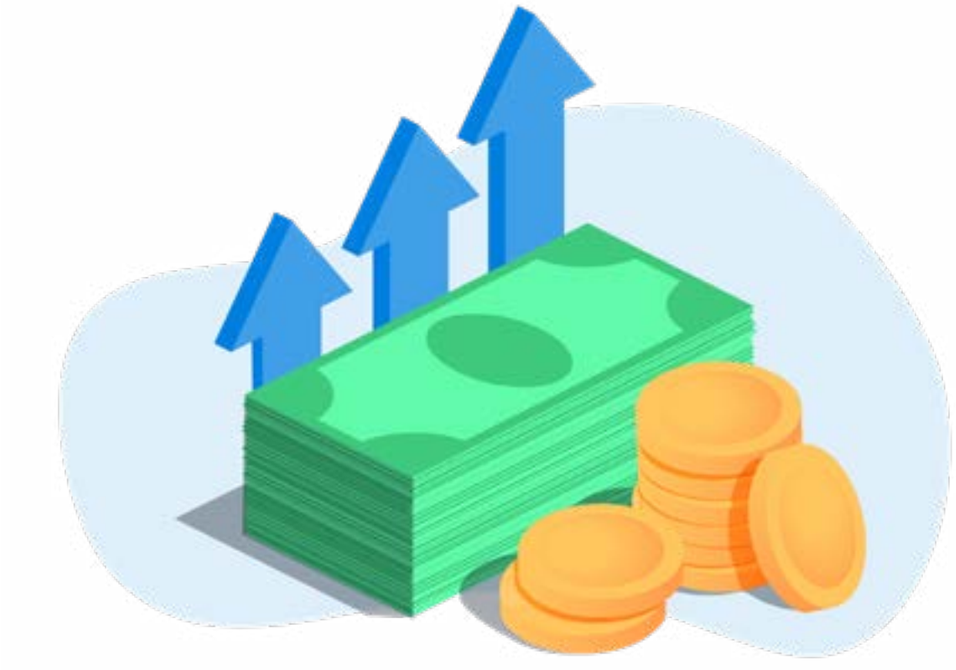
Exchange rates fluctuate based on supply and demand, but there are many factors that contribute to the supply and demand of a currency. Each of these factors are interrelated and affect each other as well as the value of currency.

Some of these incude:

- Monetary policy
- Inflation
- Interest rates
- Terms of trade
- Account balance
- Government debt
- Political and economic stability
- Speculation

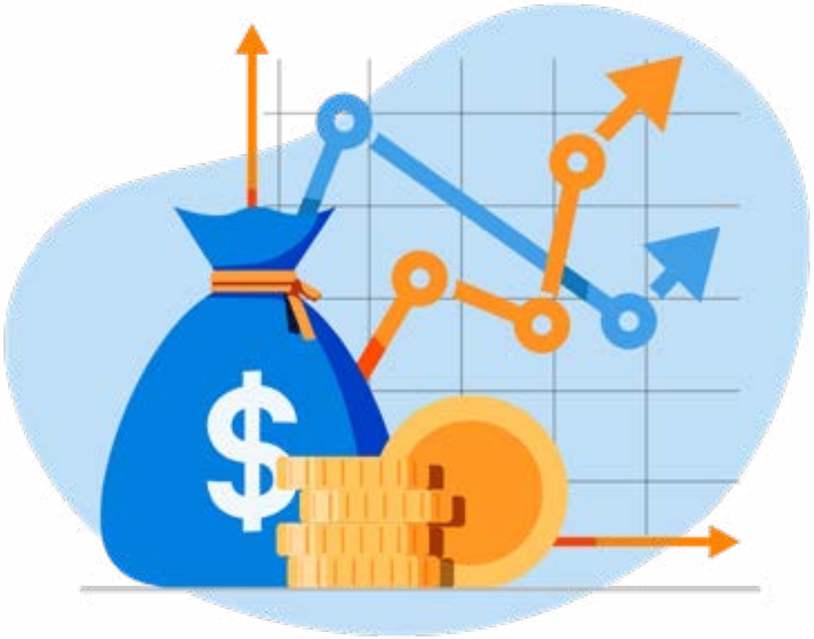
Monetary policy

A country's **monetary policy** outlines how the central bank governs the supply of money. The bank may increase or decrease the amount of money in circulation depending on the needs of the economy. The more money in circulation, the less it's worth and the cheaper it is to exchange. At extreme levels, hyperinflation could result. Central banks need to be careful with these strategies. Putting more money in circulation can boost the economy, but may also increase inflation.



Inflation

Inflation is the increase in the price of goods over time. The inflation rate is the overall increase in prices from one year to the next. Most central banks aim for a healthy inflation rate of 2%. High inflation lowers the value of a currency. For example, if Canada's inflation rate is higher than the US, the Canadian dollar falls in value so their exports can still be competitive in US markets.



Interest rates

Interest rates are set by a country's central bank and determine the price of borrowing money. Countries aim to balance their interest rates with inflation. If inflation gets too high, the government might increase interest rates to reduce spending and help increase the value of the country's currency. High interest rates make it more attractive for people to invest money in that country, which means they need to buy that currency, which in turn means the value of that currency increases.

Terms of trade

Terms of trade refers to the ratio between a country's export and import prices. Terms of trade are improving when a country's export prices rise at a greater rate than their import prices. This means there's a greater demand for a country's exports, so the value of their currency rises.

Account balance

An account balance refers to a record of a country's transactions with the rest of the world, similar to having a record of your own personal transactions. A negative account balance means the country has a deficit because they spend more on imports than the value of their exports. A deficit weakens the value of the country's currency. But if there are foreign investors willing to finance a country's deficit, a deficit can be sustained for a long period of time. When the account balance is in surplus, the country exports more than it imports. This can happen once the currency falls in value, making imports more expensive and exports cheaper for other countries.

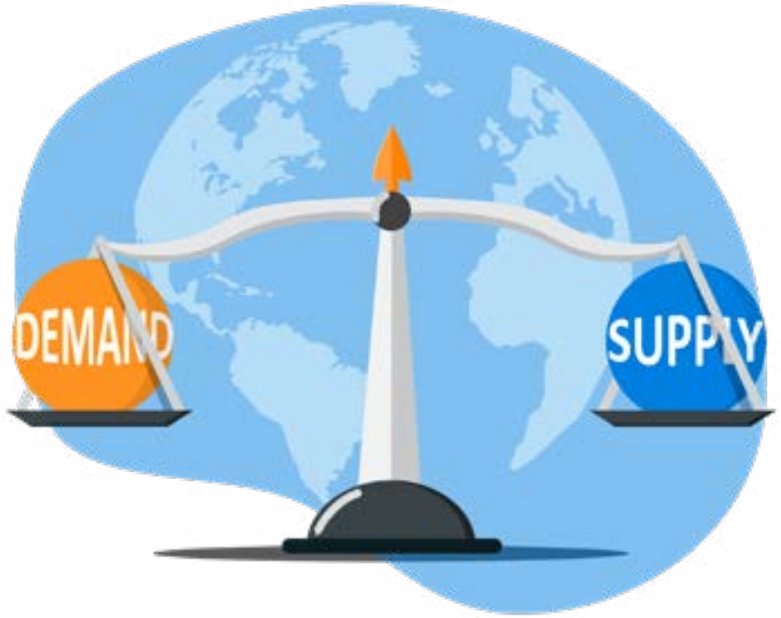
Government debt

Government debt refers to how much the country owes lenders outside the country. These could be individuals, businesses, or governments. When looking at a government's debt, it's important to keep the size of their economy in mind.

A country with a high national debt might have a lower valued currency because foreign investment is unlikely. However, the US is an example of a country with a high national debt, but because of the size of their economy and the strength of their currency, they still attract plenty of investors.

Political and economic stability

A country with constant political upheaval or economic crises will see a decrease in the value of their currency. Foreign investors prefer countries that are politically stable with sound economic policies. But if a new government has been established and seems stable, the value of the currency might increase.



Speculation

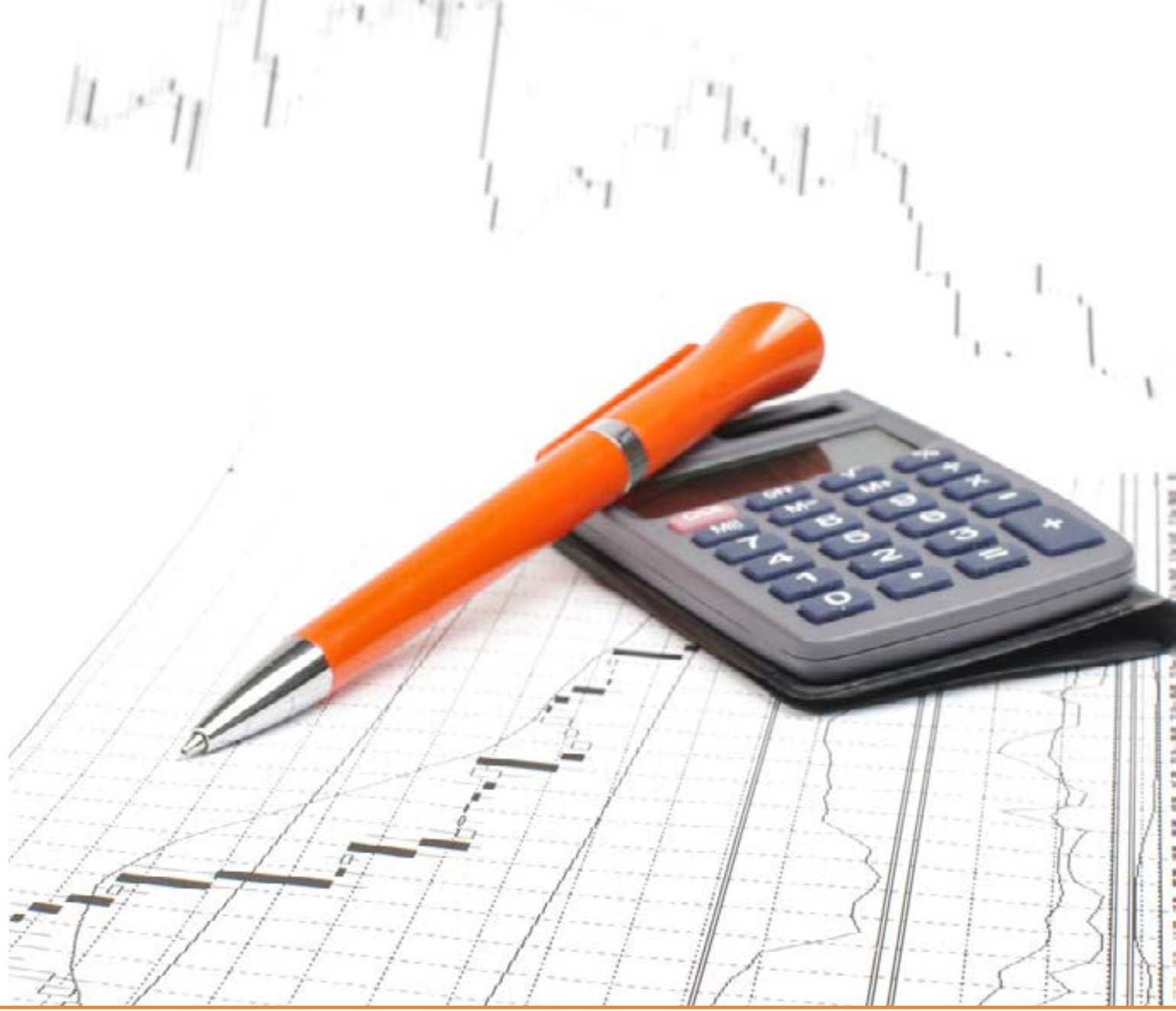
Exchange rates don't just change based on what's currently happening. Sometimes just news that interest rates will rise causes an increase in a currency's value. If a currency's value is expected to rise, there will be more demand, so the exchange rate also rises.

How are exchange rates calculated?

When you Google an exchange rate, you'll see a value and a graph showing fluctuations over time. If you could exchange your money at that rate, we wouldn't have much to explain. But this rate is called the mid-market rate. Think of it as a ground zero. You won't be able to find this rate at any bank, currency exchange kiosk, or online payment service.

Remember when we said to think of currency as a commodity? When you're buying or selling currency, the bank or service you're doing business with wants to make money. Banks are the biggest traders of currency. The mid-market rate is what banks use when they trade between themselves. But for their customers, banks mark up exchange rates by around 3-5%. This means that they charge more than the mid-market rate if you're buying a currency, and offer less if you're selling.

The real losses from exchange rates can be detrimental to a small business if they're not planned for and hedged against. This danger is called exchange rate risk. Of course, if affects companies who import and export. But it also affects any business that sells to customers in other countries.



How can you manage exchange rate risk?

Exchange rate risk (also referred to as currency risk, foreign exchange risk, or FX risk) refers to how the fluctuating value of currencies makes revenue and expenses so unpredictable. You might make an agreement with an overseas client, but by the time they're required to make a payment, that amount could be much less when converted to your country's currency. For example, a US-based business sells a certain amount in Euros each month. They might always sell the same amount in Euros, but if the value of the Euro has dropped, they'll be generating less revenue than predicted. On the other hand, if a company has expenses in Euros, a reduction in value will save them money. While foreign exchange rates sometimes play in your favor, the uncertainty of trading internationally without a strategy is damaging for the growth and competitiveness of your business.

Here are a few ways businesses can mitigate this risk:

- **Forward contracts:** A forward contract is an agreement between a buyer and seller. Both parties agree to a price at a fixed exchange rate that will be paid-for at a later date. This allows you to lock in an exchange rate and guarantee the money you'll be receiving or paying. However, if the exchange rate fluctuates in your favor after the contract is signed, you'll be losing out on that potential profit.
- **Payment in USD:** Business owners could put the exchange rate risk on buyers rather than on your business by requiring payment in US dollars, but this strategy can limit your business.
- **Increased prices:** Another option is to increase the price of your goods in countries where the exchange rate is relatively predictable. However, this might also make your product less competitive, and you'll need to remember to decrease prices for your customers in that country when the exchange rate swings the other way.

Many businesses ignore the exchange rate risk and hope everything will ultimately work out in their favor. Sometimes businesses just don't have a clear picture of how much revenue is being generated in foreign currencies. And while there are many strategies available, the easiest first step is to make sure you're being offered a fair exchange rate. In the case of banks, credit cards, and companies like PayPal, you might be losing a lot of money that could be saved. In addition to high foreign transaction fees, these services mark up their exchange rates significantly. Sometimes what is marketed as a 0% commission transfer is really a price that hides the extra fees in the exchange rate. The good news is, there are alternative payment solutions that provide competitive and transparent exchange rates.

Veem exchange rates: competitive, and locked

What's more, Veem also offers the ability for customers to hedge their currency exchange with our "Locked Rates" feature. With Veem's Locked Exchange Rates, companies can mitigate risk and budget, plan and forecast more accurately by knowing their exchange rate in advance. With this feature, what was once big business best practice for foreign exchange is available to everyone.

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