Research on Foreign Exchange Risk Management Strategies for Small and Medium-sized Foreign Trade Enterprises

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Abstract: Since the “811” foreign exchange reform, the RMB exchange rate has been further market-oriented, forming a two-way floating against the US dollar, and the foreign exchange risk of domestic foreign trade enterprises increasing day and day. This paper points out and analyzes the practical problems of small and medium-sized foreign trade enterprises dealing with foreign exchange risks, puts forward foreign exchange risk management suggestions, and introduces the use and utility of foreign exchange options portfolio with case analysis, so as to provide certain countermeasures and suggestions for foreign exchange risk prevention for small and medium-sized foreign trade enterprises.

Keywords: Small and medium-sized foreign trade enterprises; Foreign exchange risk; Hedging; Option portfolio

DOI: 10.47297/wspciWSP2516-252706.20200411

In the “811” foreign exchange reform in 2015, the central parity rate of RMB was adjusted with reference to a basket of currencies, which improves the rationality of the central parity rate quotation and better reflects the change of supply and demand power in the foreign exchange market. Since then, the ten-year unilateral appreciation of the RMB against the dollar ends and the two-way floating elasticity increase, which means that the direction and range of exchange rate fluctuations are more uncertain. At the same time, with the continuous advancement of the RMB internationalization process, some bulk trade began to accept the settlement of RMB. However, for small and medium-sized foreign trade enterprises with poor bargaining power, they basically used USD, euro and other foreign exchange settlement. The appreciation of the RMB has caused losses to export enterprises receiving currency by the US dollar and the euro. On the other hand, it also increases the cost of China’s export goods and gradually loses its competitive advantage. For small and medium-sized foreign trade enterprises to survive in the gap of internal foreign exchange reform and deteriorating external trade environment, they must prevent foreign exchange risks and keep their meager profits. This is an urgent problem to be solved.
1. Foreign Trade Enterprises Face the Practical Problems of Foreign Exchange Risks

Foreign exchange risk refers to the possibility of foreign trade enterprises to suffer losses due to exchange rate fluctuations in international economic exchanges. In the process of operation, foreign trade enterprises will inevitably collect and pay a large amount of foreign exchange on the international scale, or have the creditor’s rights and debts expressed in foreign currency. When the exchange rate changes suddenly, it causes value uncertainty, foreign trade enterprises may gain benefits, or suffer losses.

After investigation, small and medium-sized foreign trade enterprises often face foreign exchange risks:

(1) Did not pay enough attention to the foreign exchange risks
Small and medium-sized enterprises generally think that foreign exchange risk is an ordinary financial problem, which can be dealt with by financial personnel. However, financial personnel are not foreign exchange risk management professionals, they do not know how to use foreign exchange financial derivatives to hedge and prevent risks. In practice, enterprises mostly adopt natural hedging methods such as adjusting the payment time, changing the settlement currency, settlement, payment and purchase, and the foreign exchange risk exposure is large.

(2) Improper understanding of hedging
The decision makers believe that the value of hedging lies in locking the exchange rate is profitable compared to the spot exchange rate on the date of performance, and brings profits for the enterprise. If hedging only locks the exchange rate and cannot bring profits, companies would rather accept the losses from exchange rate fluctuations than bear the costs of foreign exchange risk management.

(3) The cost of Syria doing hedging is relatively high
Due to the lack of small and medium-sized foreign trade enterprises granting credit in banks, they often need to pay margin when using foreign exchange financial derivatives to make hedging. Some small and medium-sized enterprises are not willing to bear this financial cost, so they give up foreign exchange risk management.

2. Analysis of the Existing Problems in Foreign Trade Enterprises

(1) Enterprises are lack of foreign exchange risk education
Small and medium-sized enterprises are limited by their own scale and have few channels for foreign exchange risk education, causing them not to recognize the harm caused by foreign exchange risks. According to the China Foreign Exchange
Exchange Center, since the 811 reform, the lowest USD / RMB central parity rate is 6.2764 on April 2, 2018, and up to 7.1316 on May 29, 2020, with a difference of 8,552 bp. This huge exchange rate difference could cause incalculable losses to a small and medium-sized foreign trade enterprise. Moreover, foreign exchange risk is not a general financial risk, which requires professionals to correctly avoid through financial instruments or other means. The essence of avoiding foreign exchange risk is to lock the exchange rate, control the exchange rate risk to a certain extent, and replace the risk with certainty, rather than speculative profit. Only by correctly understanding small and medium-sized foreign exchange risk and medium-sized enterprises can they adopt correct strategies to prevent it and not lose in the drastic changes of exchange rate.

(2) Financial institutions do not pay attention to the foreign exchange business of small and medium-sized enterprises

Banks and other, due of interests, financial institutions tend to serve large enterprises to manage foreign exchange risks and ignore the publicity and promotion of small and medium-sized enterprises. Most small and medium-sized enterprises do not understand foreign exchange risks or how to prevent foreign exchange risks, so small and medium-sized enterprises rarely use financial tools to avoid foreign exchange risks. According to the business regulations of financial institutions, small and medium-sized enterprises often need to pay margin for hedging under the lack of credit lines, which makes small and medium-sized enterprises once again discouraged.

3. Foreign Exchange Risk Management Suggestions

(1) Establish a risk-neutral financial awareness, and correctly understand the purpose of hedging.

Clear channels, form an interactive exchange platform for foreign exchange bureaus, banks and enterprises, and publicize the harm of foreign exchange risks and the significance of hedging. And timely interpret the RMB exchange rate policy, analyze the exchange rate risk faced by enterprises after the two-way fluctuations of the RMB exchange rate, so that enterprises can fully realize the nature of the exchange rate hedging, and lock the exchange rate in advance. Replace the risk with certainty, and help the enterprises to establish a risk-neutral financial awareness. Financial institutions should actively promote financial instruments and successful cases to prevent foreign exchange risks, so that enterprises can have rules to follow, strengthen the ability to use financial instruments to avoid foreign exchange risks, and improve the enthusiasm of foreign exchange risk management.

(2) Improve the awareness of foreign exchange risk management from top to bottom

The decision-making layer within the enterprise should actively participate in
the foreign exchange policy training in the superior or the industry, and improve the overall awareness of the management personnel from the perspective of the overall foreign exchange risk management of the enterprise. The foreign exchange risk management of the enterprise needs to hire or cultivate compound talents with foreign exchange related knowledge in combination with their own production and operation mode. Most of the enterprise employees are familiar with their own production, operation and financial management knowledge, but they are not familiar with the foreign exchange market. Enterprises regularly organize foreign exchange financial business experts to train the enterprise foreign exchange business operators, and improve the employees’ sensitivity to foreign exchange risks.

(3) Use foreign exchange derivatives to improve the foreign exchange risk prevention ability

At present, the main foreign exchange financial derivatives products in the foreign exchange financial market include forward foreign exchange, foreign exchange options, interest rate swaps, etc. The following takes the foreign exchange options portfolio as an example to avoid the interval exposure to exchange rate changes. Foreign exchange options portfolio refers to the combination of buying a foreign currency with the same currency, term and contract principal.

1) Anti-Put portfolio

Businesses have a future foreign exchange income that, to prevent falling foreign exchange rates, buy a lower executed foreign exchange put option while selling a foreign exchange call with a higher executive price.

Enterprise A will receive a $1 million export payment in three months. In order to avoid the risk of USD depreciation, the enterprise A purchased a USD / RMB with a term of 3 months and a principal of USD 1 million from the bank, with an execution price of 6.5; Also selling a dollar call with the same currency pair, the same term, the principal to the bank at an executive price of 6.6. The option fee charged for selling the option basically offset the option cost for buying the option, and the cost is basically 0.

If the market spot rate is 6.4 at the time of the option, Enterprise A exercises the bought put option, the bank waives the call option, and the customer sells $1 million to the bank at the price of 6.5. In this case, the enterprise A exchange settlement price is better than the market price.

If the market spot exchange rate is 6.7 at maturity, Enterprise A waives the exercise of the put option and the bank exercises the call option, and Enterprise A shall perform the obligation to sell $1 million to the bank for 6.6. In this case, Enterprise A lost the opportunity to settle settlement at a more favorable price. However, through Syria option portfolio trading, the enterprise A has locked the future foreign exchange settlement income within 6.50 ~ 6.6 million yuan on the
date of contract signing, reducing the uncertainty of the future.

Figure 1: Pput portfolio

2) Pay exchange anti-rise options portfolio

Businesses have a future foreign exchange expenditure, to prevent rising foreign exchange rates, selling a lower executive priced foreign exchange put option while buying a foreign exchange call with a higher executive price. Enterprise B needs to pay $1 million for import goods in three months. In order to avoid the risk of appreciation of the dollar, the enterprise B sold a put option of RMB to the dollar with a term of 3 months and the principal of $1 million to the bank, with the execution price of 6.5; At the same time, buy a European call option with the same currency pair, term and principal from the bank, with an execution price of 6.6. The option fee charged for selling the option basically offset the option cost for buying the option, and the cost is basically 0.

If the market spot exchange rate is 6.7 at the expiration of the option is 6.7, the enterprise B exercises the purchased call option, buys $1 million from the bank at 6.6, and the bank waives from the purchased dollar put option; In this case, the enterprise B foreign exchange exchange price is better than the market price.

If the market spot exchange rate is 6.4 at maturity, Enterprise B waives the exercise of the purchased call option and the bank exercises the put option, Enterprise B shall fulfill the obligation of buying $1 million at 6.5. In this case, the corporate B has lost the opportunity to purchase foreign exchange at a more favorable price. Through the option portfolio trading, the enterprise B has locked the future foreign exchange purchase cost within 6.50 ~ 6.6 million yuan on the contract signing date, reducing the future uncertainty.
4. Conclusion

Under the new rules of two-way changes of the RMB exchange rate and the internal and external pressure of the deteriorating international trade environment, the foreign exchange risk of foreign trade enterprises increases. Foreign exchange risk not only affects the production cost of the enterprise, but even affects the survival and development of the enterprise. Small and medium-sized enterprises can no longer escape foreign exchange risk management. Effective foreign exchange risk management can not only enhance the competitiveness of the international market, but also lay a foundation for the sustainable development of enterprises.

References