



The GARP Risk Series

MARKET RISK MANAGEMENT

Chapter 2 | Foreign Exchange Markets, Instruments and Risks

Currency Regimes

- **Determine to what extent a country's government manages its currency relative to other currencies**
- **Free float**
 - A currency's value varies freely
 - Market determines the value
 - Managed float
 - Active intervention in the markets to maintain the exchange rate within an "acceptable" range
- **Fixed exchange rate**
 - A currency's value is fixed to the value of another currency or a basket of other currencies
 - The value of the currency is "pegged" to another currency
 - The HKD is fixed against the USD
 - Exchange rates move in a band between 7.75–7.85 USD/HKD

Exchange rate data and volatility calculated by Bloomberg.

Primary Source of Foreign Exchange Rate Risk

- **Pure currency float**

- Market determines rates
- The value of the currency appreciates or depreciates freely
 - Interest rates, economic conditions, expectations
- Typically smaller but regular changes

- **Fixed currency system**

- Change in currency regime
 - A previously fixed currency becomes floating
 - The rate is adjusted
- Typically substantial but infrequent changes
- Political risk

Example of Foreign Exchange Rate Risk

- Foreign exchange risk
 - The potential loss due to currency exchange rate fluctuations

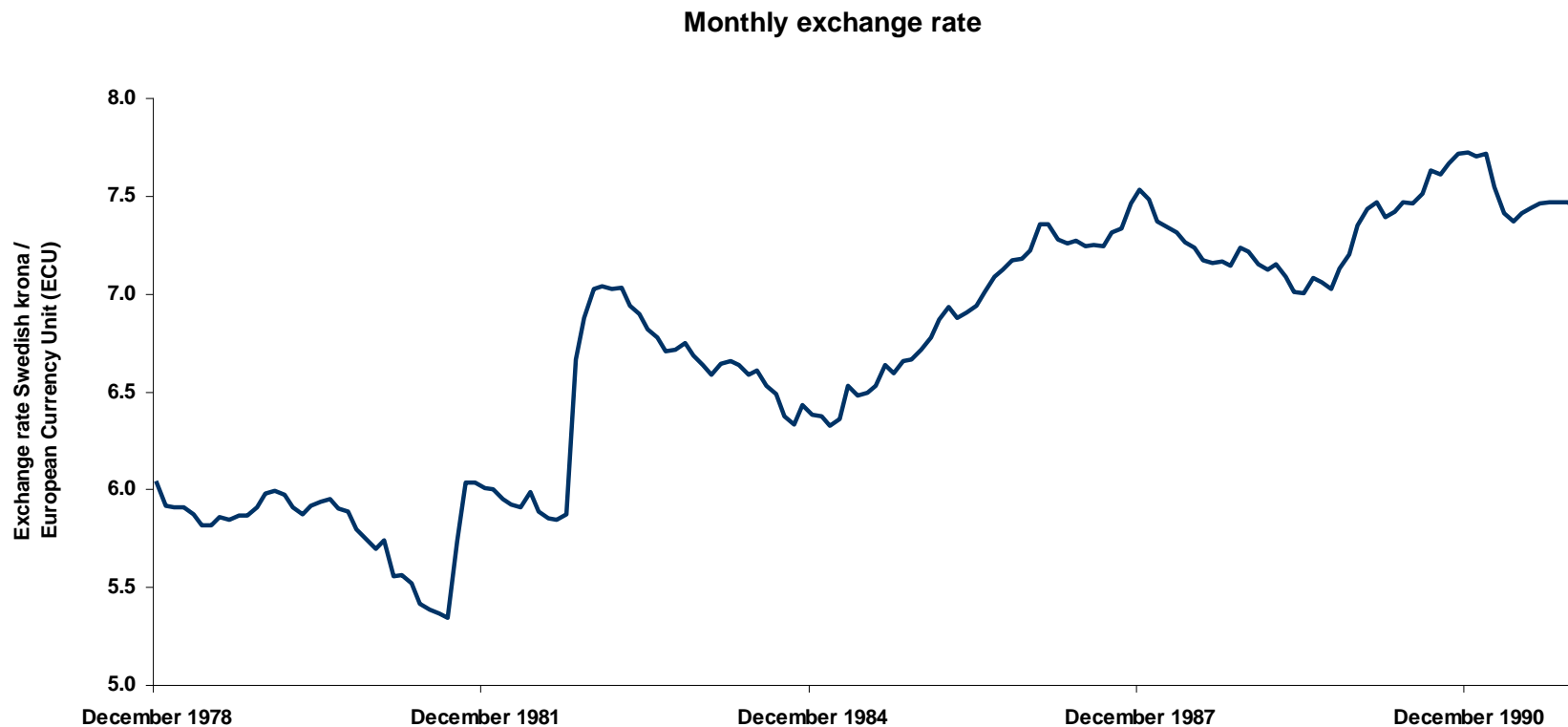
Monthly exchange rate



Swedish Kronor to One U.S. Dollar, Noon buying rates in New York City for cable transfers payable in foreign currencies. Monthly average rate from Board of Governors of the Federal Reserve System; available through St. Louis FRED database.

From Fixed to Floating Interest Rate Regimes

- Foreign exchange risk
 - The potential loss due to currency exchange rate fluctuations



Swedish Kronor to One European Currency Unit. Daily fixing rate at 9.30 a.m; from the Riksbank. Devaluation information from the Riksbank.