"African market – Growing Forex Risk and means to manage"

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The world is increasingly getting smaller due to rapid strides made in communication technology. Technology and reduced international business barriers are playing a crucial role in boosting international business.

Elimination of restrictive international trade barriers, capital controls among others have contributed for promotion of free commerce across distance and political boundaries. Though international business opens new business opportunities, it simultaneously throws certain challenges. One such challenge is foreign exchange risk management. International businesses are increasingly inheriting foreign exchange risks on the back of economies opting for much desired flexible foreign exchange regime. Businesses engaged in foreign trade transact in foreign exchange, thus, exposed to the risk associated with adverse directions in foreign exchange rates.

Excessive volatility of foreign exchange rates will bring uncertainty and therefore make it difficult for various stakeholders to manage current cash flows, project future business expansion and investments. In the current competitive market environment, this will eventually hurt their business growth.

With Africa growth story riding high, there is an increased flow of global investment and trade moving towards

Africa in quest for higher returns. But, the associated unpredictability of exchange rate movements is impacting stakeholders. Hence, there is a need to evaluate and understand the foreign exchange risk of various stakeholders doing business in Africa and ways to tide over it.

Africa's Growing Foreign Trade

African economies have made much progress in global trade policy. The export and import tariffs are now close to other developing countries and quantitative restrictions have been largely limited. Reforms have been directed towards improving competitiveness and investing in measures to facilitate global trade. African exports have grown dramatically in the last few years, except in 2009 due to aftermath of global financial crisis, increasing from US$ 376 billion in 2005 to US$ 630 billion in 2012 (refer figure 1). Africa's share of world trade rose from 2.9 percent to 3.4 percent (refer figure 2) and the trade balance is in surplus. With US$1 trillion on the cards soon, it clearly underlines the forex risk being carried by exporters and importers associated with Africa's foreign trade apart from financiers of those traders.

Africa set to become prominent investor destination

There is increased optimism shown by the global investor fraternity in African economies and financial markets (refer figure 3). The FDI was on the rise except for 2009 (post global financial crisis) and intermittent dip in GDP growth rate did not slow down FDI inflows. Indeed, one of the lead global business consultancy firms stated that capital investments in Africa are set to touch US$150 billion by 2015. An increase in foreign investment stresses the need for effective forex risk management to ensure sustainable capital inflow. A sustainable inward flow is very much essential considering the huge

Figure 1: Africa - Exports and Imports

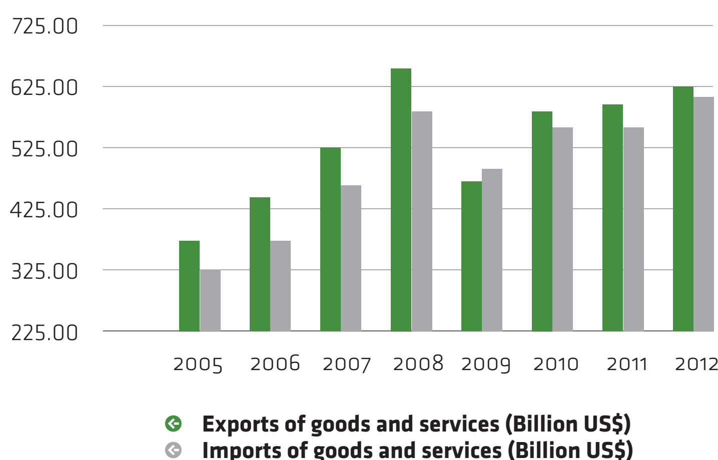
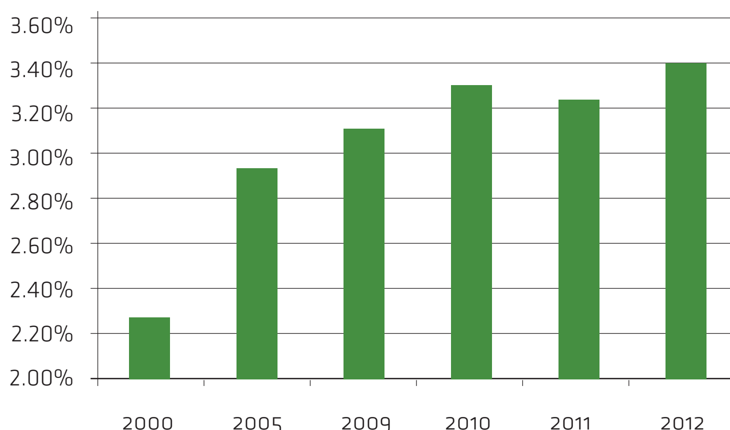


Figure 2: Africa's exports as share of world's exports (%)



appetite for capital in Africa.

Volatility of currencies to impact stakeholders

Market participants (including exporters, importers, producers, traders and investors) are increasingly being exposed to currency rate fluctuations with growing involvement of Africa in global trade. Usually, volatility of exchange rates is influenced by factors such as deviation from fundamentals, excessive speculative activity and macroeconomic shocks. Excessive volatility in exchange rates could spill over to other segments of financial markets and eventually distort monetary policy signals leading to financial stability problems. Since 2011, key African currencies have depreciated against the US dollar (Figure 4). On top of that, existence of forex volatility in a range of 5-20 percent (Table 1) adds to the uncertainty level. For instance, in 2011, African currencies experienced significant volatility levels. During that period, Africa's economic recovery faced challenges from global economic stagnation, the European debt crisis, the United States' credit rating downgrade, and spike in fuel prices due to unrest in the Middle East regions. These

contributed to uncertainty in the financial markets causing major depreciation of African currencies. Thus, currency risk associated with investing in Africa by different stakeholders is perceived as real.

Impact of Exchange rate volatility

Upward or downward movement of forex rate impacts stakeholders in the following ways:

Exporters/Importers:
Foreign exchange volatility impacts both exporters and importers. For instance, depreciation of domestic currency benefits exporters, while it adversely affects importers as import cost goes up. On a further note, highly interconnected production networks also imply that the impact depends on the extent of imported inputs in exports. Thus, increase in import cost adversely affects competitiveness of such exports in the global market.

Consumers: In global trade, the price of a finished product goes up in accord with perceived market risks. For a product with a long supply chain consisting of multi layers from production till final consumption, the scope of perception of forex risk grows manifold due to elongated time and multiple transactions depending upon number of intermediaries. Consequently, consumers end up paying far more than the "true value" of the product.

Corporate: Given the global interconnectedness, fast growth in cross-border trade and investments flows, financial planning horizon for any corporate/firm (in terms of portfolio rebalancing) is of utmost importance. Investors are not only concerned about what happens at the end of their investment horizon, but they also care about what happens along the way. Therefore, currency risk may substantially increase the magnitude and/or likelihood of a drawdown.

Commercial Banks: Uncertain movement in exchange rates also pose a threat to earnings and capital of commercial banks, especially if the movement is in an adverse direction. Commercial banks actively dealing in foreign currencies holding assets and liabilities in foreign denominated currencies are constantly exposed to foreign exchange risk.

Demystifying the currency hedging conundrum

As investors broaden their investment horizon by expanding into foreign stocks and bonds, they must also bear the risk associated with fluctuations in exchange rates. Assume a US-based investor purchases a Nigerian stock for NGN 1000. While holding this stock (assuming the price of the stock remains unchanged), Naira exchange rate gained from 160 to 150 Naira per US dollar. Now, when the investor sells the stock, he or she will realize a loss of approximately 7 percent upon conversion of the returns from Naira to US dollars.

Hedging forex risks can be done in two ways; first, through financial hedge and second through operational hedge such as diversifying markets or invoicing in domestic currency. But, diversifying markets require expanded scale of production which is difficult for small firms. Invoicing in domestic currency is also difficult since the risk is passed on to the counterparty. As a matter of fact, financial hedging seems to be the best bet.

Let us consider an example. Assume, a company, domiciled in Ghana agrees to sell goods to be delivered in February for a future receipt of $50,000. As a result, the company is exposed to the risk of a declining dollar against Ghana Cedi.

Suppose, it is January 18, 2014 and the spot value of the USD/GHS rate is 2 [(GHS 2 per one dollar) or (GHS/USD = 0.5)]. This implies that the current value of that forthcoming receipt of $50,000 is worth GHS 100,000.

Assume by February 17, 2014, value of US dollar weakened against the Ghana Cedi to a spot value of GHS 1.5 per one dollar (GHS/USD = 0.6667). As a result, the promised receipt has fallen to GHS 75,000.

To protect its cash flow, the company may opt for GHS/USD futures contract on an exchange platform on January 18, 2014 and eventually enter in a sell position of 50 GHS/USD Futures contract at a predetermined rate (assuming the contract size is GHS 2,000). On February 17, 2014 the company will exit from the position on the exchange platform through squaring-off by taking an opposite position.

An ideal hedging platform

Currency hedging, achieved through the use of derivative instruments such as Futures, Forwards and Option contracts, will help market participants hedge against adverse foreign exchange movement. The objective of hedging is not to make profits but to ensure that the risk exposure is covered – "best hedge ratio". Fundamentally, Forward and Futures Contracts have the same function, but there are some key differences. A Futures Contract is standardized and exchange traded while a Forward Contract is customized (agreement between two parties), and is not traded on an exchange platform.

Advantage Futures

An exchange provides a centralized location for demand and supply information to converge, thus helps in better price discovery and high level of price transparency. Since forward contracts are private agreements, there is always a possibility that a party may default on its side of the agreement. In the case of futures contracts no such risk exists as clearing house ensures sufficient margin is maintained and acts as counterparty, hence no default risk. Additionally, Futures Contracts are marked-to-market daily, which

means price/rate changes are settled everyday till the expiry of the contract. No such daily settlement 'marked-to-market' exist in Forward Contracts. Except for South African Rand, Mauritian Rupee, Zambian Kwacha and Botswana Pula, which are exchange traded, many African currencies are traded only in over-the-counter (OTC) market.

An efficient Futures market to cater for currency volatility

Currency volatility in African countries enhances investors' perception of risk in these markets and discourages much needed capital inflows that tend to support economic growth. There have been some attempts by central banks of African economies to correct this situation by tightening monetary policy to tame rising inflation and stabilize the exchange rate. However, this usually comes with the risk of undermining short-term economic growth. An efficient futures market offering currency risk management instruments such as currency futures are seen as the most prominent tool available to cater for market participants' vulnerability to the vagaries of excess currency volatility.

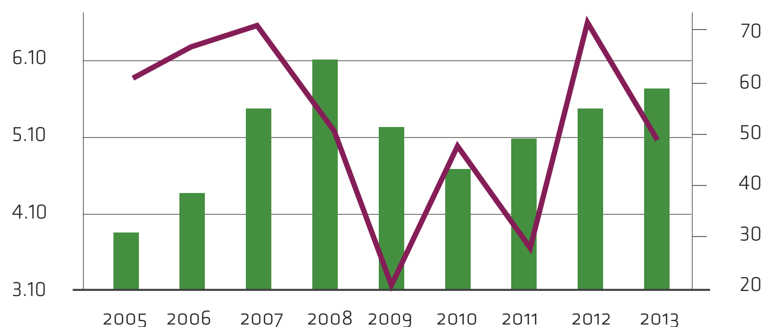
However, many of the exchanges in Africa are not well equipped with technology. Lack of liquidity is also another impediment facing these exchanges. Therefore, a Pan-African exchange with Africa centric products can bridge the accessibility gap by providing the real-time information about many African products to the world, hence, enhancing participation and thereby increasing liquidity. A Pan-African exchange will provide African and International market participants with an efficient market for risk management, trading, investing and capital raising needs. It will help slow the often seen capital flight out of these countries when their economies suffer setbacks, and act as a catalyst for the growth and development of the underlying commodity, currency, equity and debt markets. In today's competitive global business environment, it is high time for Africa to establish a robust Pan-African exchange that offers the services required by the continent's economies.

Table 1: Annualized Volatility (%) – Comparison of Key African and European Currencies

(FX rate against the US$)	2010	2011	2012	2014
Ghana Cedi	5.8	6.6	6.6	7.4
Kenyan Shilling	6.7	11.6	5.7	4.4
Nigerian Naira	5.4	10.6	5.2	5.7
South African Rand	12.7	19.4	13.9	13.6
Euro	12.0	11.9	8.2	7.4
British Pound	10.1	8.4	6.3	7.5

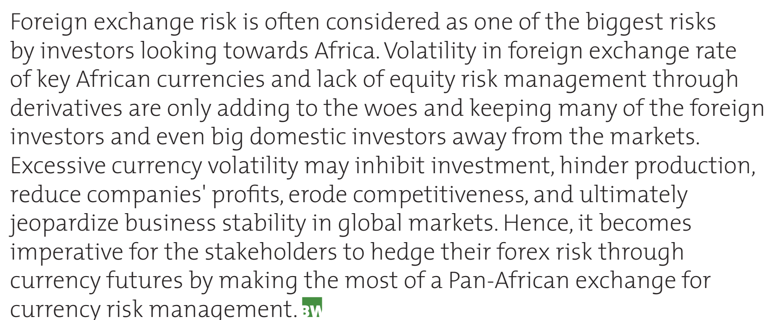
Source: Bloomberg & Bourse Africa Research

Figure 3: Africa - FDI Inflows & Real GDP Growth



Foreign direct investment, net inflows (Billion US$)
Real GDP Growth Rates (%) Left Scale

Conclusion



Foreign exchange risk is often considered as one of the biggest risks by investors looking towards Africa. Volatility in foreign exchange rate of key African currencies and lack of equity risk management through derivatives are only adding to the woes and keeping many of the foreign investors and even big domestic investors away from the markets. Excessive currency volatility may inhibit investment, hinder production, reduce companies' profits, erode competitiveness, and ultimately jeopardize business stability in global markets. Hence, it becomes imperative for the stakeholders to hedge their forex risk through currency futures by making the most of a Pan-African exchange for currency risk management. BW