**MBA 6033: International Business Management**

**Module 10:**

**Chapter Opening Case: Exchange Rates and the Profitability of Korean Airlines**

You are about to read a short case detailing the implications of currency movements on South Korea’s two major airlines. In 2019, both airlines reported losses due to currency movements. You will be asked to answer questions linking your knowledge from the chapter to the situation detailed in the case.

This activity is important because as a manager, you must be able to understand exchange rates. In particular, it is important to recognize why exchange rates move, the implications of those movements on your business, and where exchange rates might go in the future. A variety of exchange rate forecasting services are available to help companies determine exchange rates in the future; however, some argue that the best predictor of future exchange rates are forward rates. The goal of this activity is to demonstrate your understanding of exchange rates and their movements, and the impact of those movements on business.

*Read the case and answer the questions that follow.*

In May 2019, South Korea’s two major airlines—Korean Airlines and Asiana Airlines Inc.—were hit by foreign exchange losses arising from the weakness of the Korean won against the U.S. dollar. Korean Air announced that it posted 148.20 billion won (US$124.49 million) in operating profit from January to March, down 16.2 percent from the same period a year ago. Asiana Airlines announced on the same day that its operating profit in the first quarter had declined 89 percent to 7.20 billion won (US$6.05 million) from a year earlier. In February 2020, it happened again. Asiana Airlines announced that for the three months that ended on December 31, 2019, net losses widened to 234.8 billion won (US$199 million) from 163.9 billion won a year earlier due to foreign exchange losses.

These foreign exchange losses arose from two sources. First, like the oil from which it is derived, in the global marketplace jet fuel is priced in U.S. dollars. Hence, any fall in the price of the won against the U.S. dollar drives up fuel purchasing costs when translated back into won. Second, Korean Airlines and Asiana Airlines have both taken on dollar-denominated debt to finance their purchase of jet aircraft from Boeing and Airbus, both of which are also priced in U.S. dollars. They have done this because interest rates on dollar-denominated debt have been significantly lower than interest rates on won-denominated debt. However, borrowing in a foreign currency brings with it an exposure to foreign exchange risk. A fall in the price of the won against the U.S. dollar will drive up the costs of servicing that dollar-denominated debt when translated back into Korean—and that is exactly what has happened.

So how much has the won fallen against the U.S. dollar recently? In mid-February 2018, one U.S. dollar was trading at around 1065 won. By mid-February 2020, one US dollar bought about 1,200 won. Put differently, the won had depreciated in value against the U.S. dollar by around 12.5 percent. When the dollar cost of jet fuel and debt service, both paid for in dollars, was translated back into won, this implied a 12.5 percent increase in costs of these Korean airlines over this time period and, consequently, a fall in their profitability.

The decline in the value of the won against the dollar has primarily been driven by economic uncertainty created by America’s tariff-raising binge since Donald Trump became president and a desire on the part of investors to put their money in safer assets that are less vulnerable to disruption from American-imposed tariffs and trade conflict. Those safe assets have included U.S. Treasury bills. So investors have taken their money out of other currencies, including Korean won, and put them in U.S. dollar assets. This increases demand for dollars and reduces demand for won—hence, the depreciation in the value of the won against the dollar over the last two years.

Looking forward, economic uncertainties seem to be increasing due to the spread of coronavirus in early 2020, and the global pandemic of COVID-19 infections. Economic forecasts suggest that the spread of COVID-19 could seriously disrupt global supply chains, dealing a blow to business earnings and hurting countries like South Korea that depend significantly upon international trade to drive their economies. Thus it seems possible that the won will decline further against the U.S. dollar, which will cause all sorts of financial pain for both Asiana and Korean Airlines.

Sources: Kim Bo-eun, “Won Expected to Lose More Dollar against the US Dollar,” *Korean Times,* February 21, 2020; Michael Herh, “South Korea’s Two Biggest Airlines Hit Directly by Currency Depreciation,” *Business Korea,* May 16, 2019; “Asiana Airlines Q4 Loss Widens on Currency,” *Yonhap News Agency,* February 12, 2020.

**1a. What has happened to the value of the South Korean…**

What has happened to the value of the South Korean won relative to the U.S. dollar from January to July given the following information? January USD1 = WON1,000; July USD1=WON1,200

Top of Form

Multiple Choice

The won has appreciated against the dollar.

The won has depreciated against the dollar.

The dollar has depreciated against the won.

The won has appreciated by about 15 percent.

The dollar has depreciated by about 15 percent.

**1b. At least some of the losses reported by the two South Korean…**

At least some of the losses reported by the two South Korean airlines can be attributed to \_\_\_\_\_\_\_\_\_\_ fuel costs associated with a \_\_\_\_\_\_\_\_\_\_ won.

Top of Form

Multiple Choice

falling, weakening

lower, appreciating

rising, weakening

lower, depreciating

rising, rising

**1c. Which type of exposure are South Korea’s airlines facing…**

Which type of exposure are South Korea’s airlines facing when they make a single purchase of jet fuel and pay for it in USD?

Top of Form

translation exposure

transaction exposure

economic exposure

ordinary exposure

single source exposure

1 d. Which type of exposure are South Korea’s airlines facing when they report their year-end results?

Top of Form

ordinary exposure

reporting exposure

transaction exposure

economic exposure

translation exposure

## Predicting Exchange Rate Movements (Keyboard Navigable Alternate Version)

Whether international businesses are concerned with the long-term profitability of foreign investment, export opportunities, the price competitiveness of foreign imports, or the short-term foreign exchange transactions that occur on a daily basis, the firm must pay attention to exchange rate movements. These movements can affect whether a deal results in a profit or a loss.

Exchange rate movements are extremely difficult to predict, though businesses need some forecasting ability to plan. A number of theories, methods, and borrowings from other disciplines have been applied to the movement of exchange rates. Some approaches work better in the short run, while others apply more appropriately to longer-term plans. Managers in international enterprises must understand the predictive power and uses of the theories and approaches to use them effectively in strategy and operations.

Select whether each factor is a better short-range predictor or long-range predictor of movement in foreign exchange rates.

A government can increase the supply of money, which makes it easier for individuals and businesses to get credit. This, in turn, can increase the demand for goods and services, which should grow at the same rate to avoid inflation.

Long-Range Predictor

2. Market traders tend to follow the actions of other traders, but the individual effects can be hard to predict.

Short-Term Predictor

Evidence reveals that various psychological factors play an important role in determining the expectations of market traders.

Short-Term Predictor

Nominal interest rate is the sum of the required “real” rate of interest and the expected rate of inflation during the loan period. A strong relationship exists between nominal interest rates and inflation rates.

Long-Range Predictor

Expectations of market traders tend to become self-fulfilling prophecies.

Short-Term Predictor

If the growth in a country’s money supply is faster than the growth in its output, price inflation is fueled.

Long-Range Predictor

**Managing Foreign Exchange Risks (Keyboard Navigable Alternate Version)**

The working of the foreign exchange market has clear implications for business. It is critical that international businesses understand the influence of exchange rates on the profitability of trade and investment deals. International business managers must understand the different kinds of risk, or exposure, and ways to mitigate that risk.

The risk introduced into international business transactions by changes in exchange rates is referred to as foreign exchange risk. Foreign exchange risk is usually divided into three categories: transaction exposure, translation exposure, and economic exposure.

*Match each description and way to mitigate the exposure with the risk area.*

Way to mitigate economic exposure

Description/example of transaction exposure

Way to mitigate transaction exposure

Description/example of translation exposure

Way to mitigate translation exposure

Description/example of economic exposure

Top of Form

Match each of the options above to the items below.

Income from the individual obligations for the immediate purchase or sale of goods and services at agreed prices; the borrowing or lending of funds in foreign currencies is affected by fluctuations in foreign exchange values.

Entering into forward exchange contracts and buying swaps can be used.

Concerned with the present measurement of past events.

Using lead and lag strategies can help accelerate payments from weak currency to strong currency countries, and vice versa.

Concerned with the long-term effect of changes in exchange rates on future prices, sales, and costs.

Distribute the firm’s productive assets to various locations so the firm’s long-term financial well-being is not severely affected by adverse changes in exchange rates.

## Foreign Exchange Market

The foreign exchange market serves two main functions. The first is to convert the currency of one country into the currency of another, and the second is to provide some insurance against foreign exchange risk.

When two companies are trying to provide some insurance against foreign exchange risk, they can either exchange the currency immediately, which is called spot exchange, or at a specific date in the future, which is called a forward exchange rate.

Select the most appropriate type of exchange rate for each description below.

1. Guarantees—Reduces uncertainty of FX transactions

Forward Exchange Rate

2. Real time—Price of currency now

Spot Exchange Rate

3. Changes—Based on supply and demand changes

Spot Exchange Rate

Future—Rates quoted 30 days, 90 days, and 180 days into the future

Forward Exchange Rate

Conversion—Happens in a day or two

Spot Exchange Rate

Majority—Two-thirds of all foreign exchange transactions

Forward Exchange Rate

## Functions of Foreign Exchange

The foreign exchange market is a market for converting the currency of one country into that of another country. An exchange rate is simply the rate at which one currency is converted into another.

The foreign exchange market converts one currency into another for facilitating the payments of imports and exports, investing in a country where the interest rates are higher, or for speculating in foreign currencies.

Select the most appropriate function of foreign exchange for each description below.

Toyota sells 10,000 cars in the United States.

Payment for Exports Correct

Apple buys 5,000 computer screens from Japan.

Payments for Imports Correct

Dell deposits $10 million in a Dubai bank.

Investment of Excess Cash Correct

GM converts $10 million to yen and then back into dollars within three months.

Currency Speculation

### The Coffee Buzz: The Impact of Exchange Rates on Coffee

You are about to read a short case detailing a situation in the global coffee market. Together, Brazil and Vietnam produce more than two-thirds of the world’s coffee. However, while Brazil is enjoying the benefit of strong revenues from its exports, Vietnam, thanks to the impact of exchange rates, is not. You will be asked to answer questions linking your knowledge from the chapter to the situation detailed in the case.

Review the text material on foreign exchange rates, and then read the following short case. When you have finished reading the case, answer the questions that follow.

Brazil and Vietnam share a common attribute. Both countries offer the perfect conditions for growing coffee and together account for more than two-thirds of the world’s coffee production. While you might expect the two countries to share similar revenue streams and investment in coffee production, planting more crops of popular beans and reducing production of less popular types, in reality, there is a vast and seemingly growing divide between the two countries when it comes to coffee.

In Vietnam, coffee growers are wondering whether it’s time to move into other more lucrative crops. Revenues from coffee exports are so low that some farmers such as Y Kua Milo are choosing to store their crops while they wait for prices to rise. As a result of changes in exchange rates, the price of robusta coffee has fallen more than 29 percent in dollars and about 27 percent in Vietnam’s currency. In contrast, thanks to a depreciating local currency, Brazil is enjoying a boom in coffee exports, so much so that farmers such as João Elvidio Galimberti are considering planting even more coffee. Why the difference? It all comes down to exchange rates.

Vietnam pegs its currency, the dong, to the U.S. dollar. As the dollar has appreciated, so has the dong. In Brazil, just the opposite has occurred. The Brazilian real has fallen sharply in value relative to the U.S. dollar, giving the country’s coffee producers a substantial boost in profits from their coffee exports. Indeed, over the last year, the real has dropped some 30 percent relative to the dollar. So, while coffee exports from Brazil jumped 21 percent last year, Vietnamese coffee exports have slumped to their lowest level in six years. Now, analysts expect that going forward, farmers in Brazil will increase coffee production, while growers in Vietnam will shift to other crops.

**6a. What type of exchange rate regime is present in Vietnam?**

Top of Form



spot



managed



floating



pegged

Correct



fixed

## 6b. Which of the following has contributed to the problems Vietnam is facing with its coffee revenues?

Top of Form

Multiple Choice

Vietnam’s currency is pegged to the dollar.

Farmers failed to hedge.

The managed float system results in variable earnings.

Most farmers decided to turn to alternative crops.

Spot prices for coffee have not kept pace with inflation in Vietnam.

**6c. Brazilian coffee farmers have benefitted from**

Top of Form

the depreciation of the Vietnamese dong.

the sharp appreciation of the local currency.

the depreciation of the U.S. dollar.

the drop in the price of robusta beans.

the drop in the value of the Brazilian real.

**6d. Which of the following statements is true of how the strong U.S. dollar has affected the global coffee market?**

Top of Form

Vietnamese coffee farmers are reducing coffee production and investing in alternative crops.

Correct

Vietnam is benefiting from high export revenue.

Brazil’s coffee exports are declining rapidly.

Brazilian growers are decreasing coffee production.

Coffee is being stockpiled in Brazil by farmers who are unwilling to sell at current prices.

**6e. Which of the following would be most beneficial for Vietnam’s coffee growers?**

Top of Form

an appreciation of the euro

a depreciation of the Brazilian real

a depreciation in the value of the U.S. dollar

an appreciation of the Vietnamese dong

a depreciation of the British pound sterling

**7a. In 2014, the value of the U.S. dollar relative to the euro was about 30 percent weaker than its value in 2001. How is a weak currency an advantage in trade?**

Top of Form

A weak currency allows citizens to consume more imports.

A weak currency implies low translation costs.

A weak currency boosts export sales for the country.

A weak currency makes a country’s imports more attractive.

A weak currency is associated with strong trade policy.

**7b. If the United States has a weak dollar relative to the euro, what is the impact for a European importer buying products from the United States that are priced in dollars?**

Top of Form

The European company will benefit from its relatively strong euro.Correct

The European company will experience no effect because of its special relationship with the EU.

The European company will demand that the products be priced in euros.

The European company will lose money.

The European company will demand that the products be priced in a third currency.

**7c. What is the impact of a strong dollar relative to the euro for a U.S. consumer buying a Porsche produced in Germany with parts from Slovakia?**

Top of Form

The car should be less expensive for the U.S. consumer.

The U.S. consumer will probably choose a used car because the imported car will be too expensive.

The U.S. consumer will probably purchase a Corvette instead.

The U.S. consumer will probably have to choose a lesser model to afford the car.

The car will cost more to reflect the higher dollar.

**7d. The relationship between the U.S. dollar and the European Union’s euro has been up and down. In 2018, for example, a strong U.S. economy together with persistent economic weakness in Europe resulted in American exports to the euro zone being 17 percent more expensive when priced in euros. Which type of exchange rate exposure are managers dealing with in this longer-term scenario?**

Top of Form

international Fisher effect

Fisher effect

economic exposureCorrect

translation exposure

transaction exposure

**8a. How does a weak currency give a country an unfair advantage in trade?**

Top of Form

A weak currency boosts exports sales for the country.Correct

A weak currency makes a country’s imports more attractive.

A weak currency implies low translation costs.

A weak currency is associated with strong trade policy.

A weak currency allows citizens to consume more imports.

**8b.** If Mexico has a weak peso relative to the dollar, what is the impact for U.S. companies importing inputs from Mexico that are priced in pesos?Top of Form

The U.S. company will demand that the inputs are priced in dollars.

The U.S. company will benefit from its relatively strong dollar.

The U.S. company will lose money.

The U.S. company will demand that the inputs be priced in a third currency.

The U.S. company will experience no effect because of NAFTA.

**8c.** What is the impact of a strong dollar relative to the peso for a U.S. consumer buying a car produced in Mexico?Top of Form

The car should be less expensive for the U.S. consumer.

The U.S. consumer will probably purchase a domestically produced car instead.

The U.S. consumer will probably choose a used car because the imported car will be too expensive.

The U.S. consumer will probably have to choose a lesser model to afford the car.

The car will cost more to reflect the higher dollar.

**Module 10 Assessment**

1. Xanon Tech, based in Washington, buys component parts from Indonesia. The Indonesian company must be paid in rupiah. Xanon Tech will rely on \_\_\_\_\_\_\_\_\_ to convert dollars to rupiah.

Top of Form

Multiple Choice

the foreign exchange market

an acquisition agreement

arbitration

local content regulations

a greenfield investment

1. Currency speculation takes place when

Top of Form

Multiple Choice

there is a simultaneous purchase and sale of a given amount of foreign exchange for two different value dates.

there is short-term movement of funds from one currency to another in the hopes of profiting from shifts in exchange rates.

the growth in a country's money supply exceeds the growth in its output, leading to price inflation.

the purchase of securities in one market are immediately resold in another to profit from a price discrepancy.

1. How are spot exchange rates determined?

Top of Form

Multiple Choice

taking the average of a basket of currencies

the interaction between demand and supply of a currency relative to other currencies

predicting future currency movements in nonmember countries

using historical average prices of different currencies

by government decree

1. A(n) \_\_\_\_\_\_\_\_\_ occurs when two parties agree to exchange currency and execute the deal at some specific date in the future.

Top of Form

Multiple Choice

arbitrage

spot exchange

carry trade

currency swap

forward exchange

1. The foreign exchange trading center in \_\_\_\_\_\_\_\_\_ has the highest percentage of activity.

Top of Form

Multiple Choice

Zurich

London

Singapore

New York

1. Assume that the dollar is selling at a premium on the 30-day dollar/euro forward market. What is true of the foreign exchange dealers' market's expectations about the dollar over the next 30 days?

Top of Form

Multiple Choice

The dollar will buy more euros with a spot exchange than with a 30-day forward exchange.

The dollar/euro exchange rate will be steady.

The dollar will appreciate against the euro.

The market is undecided about the direction of currency movement.

The dollar will depreciate against the euro.

1. The euro/dollar exchange rate is €1 = $1.20. According to the law of one price, how much would luggage that retails for $300 in New York sell for in Germany?

Top of Form

Multiple Choice

€320

€150

€360

€250

€300

Bottom of Form

Bottom of Form

1. To express the PPP theory in symbols, let P$ be the U.S. dollar price of a basket of particular goods and P¥ be the price of the same basket of goods in Japanese yen. What does the purchasing power parity (PPP) theory predict to be the equivalent of the dollar/yen exchange rate, E$/¥?

Top of Form

Multiple Choice

E$/¥ = (1 + P¥) ÷ P$

E$/¥ = P$ ÷ P¥

E$/¥ = P¥ ÷ P$

E$/¥ = (1 + P$) ÷ (1 + P¥)

E$/¥ = (1 + P$) ÷ P¥

1. Suppose that the government of Panama decided to give everyone in the country the equivalent of $10,000. Upon receipt of the money, people raced to the stores to buy furniture, electronics, and new clothes. There was such high demand for goods that producers raised prices. What is this an example of?

Top of Form

Multiple Choice

isolationism

inflation

recession

spot exchange

a planned economy

1. According to the Fisher effect, if the "real" rate of interest in a country is 5 percent and the expected annual inflation is 9 percent, what would the "nominal" interest rate be?

Top of Form

Multiple Choice

59 percent

14 percent

9 percent

5.5 percent

2.25 percent

1. The nominal interest rate is 9 percent in Brazil and 6 percent in Japan. Applying the international Fisher effect, the Brazilian real should

Top of Form

Multiple Choice

depreciate by 1.5 percent against the Japanese yen.

appreciate by 1.5 percent against the Japanese yen.

depreciate by 3 percent against the Japanese yen.

appreciate by 3 percent against the Japanese yen.

appreciate by 15 percent against the Japanese yen.

1. What happens to the value of money when hyperinflation exists?

Top of Form

Multiple Choice

Money loses value very rapidly.

All currency continues to be valued at the same amount across trade channels.

Foreign currency is valued against the U.S. dollar.

There are more goods to purchase and it costs less to buy them.

1. The value of all currency increases faster than gross national income. According to purchasing power parity (PPP) theory, the price of a “basket of goods” should be

Top of Form

Multiple Choice

the sum of the required "real" rate of interest.

roughly equivalent in each country in relatively efficient markets.

unchangeable based on the forward exchange rate.

discounted to reflect trade barriers.

focused strictly on consumer and not industrial goods.

1. Why do governments limit convertibility of their currency?

Top of Form

Multiple Choice

to control currency appreciation

to encourage capital flight

to promote neo-mercantilism

to encourage foreign investments

to preserve their foreign exchange reserves

1. A country that relies on technical analysis for forecasting exchange rate movements would know that

Top of Form

Multiple Choice

price and volume data cannot be used to determine past trends.

econometric models drawn from economic theory are best suited to predict exchange rate movements.

the foreign exchange market is efficient and forward exchange rates are the best predictors of future spot exchange rates.

since forward exchange rates are the best predictors of future spot rates, it makes no sense to invest in forecasting.

previous market trends and waves can be used to predict future market trends and waves.

1. The phenomenon of capital flight is most likely to occur when

Top of Form

Multiple Choice

interest rates are low for a prolonged period of time.

the value of the domestic currency depreciates rapidly because of hyperinflation.

governments lift convertibility restrictions on their currency.

the recovery phase of an economic depression nears its end.

a country's economic prospects are stable and indicate growth.

1. According to the efficient market school, \_\_\_\_\_\_\_\_\_ do the best job at predicting future spot exchange rates.

Top of Form

Multiple Choice

inflationary trends

government institutions

arbitration results

forward exchange rates

forecasting services

1. An example of transaction exposure is when

Top of Form

Multiple Choice

changing exchange rates persists on future prices, sales, and costs

companies have obligations for the purchase of goods at previously agreed prices.

there is an impact of currency exchange rate changes on the reported financial statements of a company.

companies borrow funds in domestic currency.

there is a long-term effect of changes in exchange rates.

1. A lag strategy involves

Top of Form

Multiple Choice

paying foreign currency payables (to suppliers) before they are due when a currency is expected to appreciate.

delaying the collection of foreign currency receivables when a foreign currency is expected to appreciate.

paying foreign currency payables (to suppliers) before they are due when a currency is expected to depreciate.

delaying the collection of foreign currency receivables when a foreign currency is expected to depreciate.

attempting to collect foreign currency receivables early when a foreign currency is expected to appreciate.

1. \_\_\_\_\_\_\_\_\_ refers to the extent to which the reported consolidated results and balance sheets of a corporation are affected by fluctuations in foreign exchange values.

Top of Form

Multiple Choice

Countertrade

Translation exposure

Transaction exposure

Carry trade

Economic exposure

Bottom of Form

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