



THE RELATIONSHIP BETWEEN CURRENCY CONVERSIONS AND INTERNATIONAL BUSINESS TRANSACTIONS: SMALL BUSINESSES AND TRAVELERS

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ABSTRACT

This research looks at currency conversions and how it affects international business transactions especially small businesses and travelers. The idea is to show the discrepancy of currency conversion and the factors that do affect currency conversion in any given time for a business person or a traveler. In order to increase small business and traveler's awareness when it comes to doing business abroad, it is imperative to understand the currency conversions, its implications, and the commitments needed to protect investments and value of the conversion exchange. Research shows that small businesses have little or no adequate knowledge of currency conversions. The paper research questions are: (1) Do foreign exchange rates uncertainty reduce the incentive of travelers and small business owners from transacting business abroad? (2) Is it necessary for travelers and small business owners to understand the relevance of foreign exchange rates and risks management?

Keywords: Currency conversions, Transactions, Small business, Travellers.

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Contribution/ Originality

This study documents a rule of thumb that the main objective of businesses is to maximize profits and minimize costs. It illustrates that the knowledge of currency conversions is very vital to all small business practitioners.

1. INTRODUCTION

Entrepreneurs are faced with financial risks in engaging in international business transactions and it is difficult for small business owners or travelers to understand why the exchange rates or currency conversion is different from one country to another country. Currency is often different from one country to another because of country's current economic status and its location on the globe. Also the currency conversions difference are due to the internal and external factors such as inflation rates, interest rates, commission rates, political and economic stability, tax rates, and other service charges. The uncertainty and costs associated to exchange rate may, therefore, be a reason of frustration for small businesses and travelers. Of course, currency conversions affect business people, travelers, importers and exporters of goods from one country to another country and somehow it does affect a nation's economy. Using the scenario of two nations, United States and Australia, for example, the US\$1 is equivalent to 1.4062 AUD, and 1 AUD equals 0.7111 US dollar, a U.S. citizens will spend more in order to travel across the pacific to visit Australia. That is because the Australian dollar is stronger than a U.S. dollar and an Australian citizen will pay less money to purchase souvenirs or anything else in U.S. and a U.S citizen will lose money due to conversion rates, inflation rates and tax rates of 1.6% added to the money exchanged. At the same token, a business person will like to invest his or her money in its country in order to avoid the fluctuation of exchange rate. A currency conversion is a rate at which one nation currency can be exchanged for another nation's currency. Currency conversion rates are determined by different factors, such as demand and supply of currency or

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goods, interest rates, inflation, political stability, economic growth. Currency conversion can make international trade incredibly tough for many businesses and travelers, hence, small businesses must protect their businesses and their profit margins from rapid changes in exchange rates, and should have a budget plan that is effective and mitigate against losses from adverse market movements. If the dollar is strong, it increases the purchasing power of US consumers abroad, the traveler or business person is willing to purchase more commodity at a cheaper price based on the value of exchange rate. In turn, this tends to boost small businesses and consumers confidence as the shift in exchange rates make Australian citizens feel wealthier with Australian dollar. Trade theory has it that U.S will either reduce importation of Australian goods which in turn will either negatively affect Australian small businesses.

2. LITERATURE REVIEW

According to [Wild and Wild \(2013\)](#) the U.S dollar is the currency that dominates the foreign exchange market and is widely used around the world. [Wild and Wild \(2013\)](#) also stated that currency conversion is used to facilitate sale, purchase, or invest directly abroad. Also, [Hill \(2011\)](#) stated that exchange rate is simply the rate at which one currency is converted into another country. He mentioned that Toyota company uses the foreign exchange market to convert the dollars that they earned from selling cars in the United States into Japanese yen. He also stated that without the foreign exchange market, international trade and international investment would not have been possible. He further says that in 2001, a dollar can buy a euro at 1.065 but by early 2012 a dollar was able to buy euro at 0.76, it means that the dollar has fallen in value against euro. For this reason, United States goods became cheaper in Europe, thereby, boosting export sales. At the same token, it made European goods more expensive in the United States, which hurt sales and profits of European firms that sold goods and services to the United States. [Hill \(2011\)](#) expressed that there are few main uses of foreign exchange markets, first, the payments a firm receives for its exports or the income it receives from foreign investments. In order to use the funds in its home country, the firm must convert the funds into its home currency. The second function of foreign exchange market is when a firm must pay a foreign company for its products or services in its country's currency. Third function of foreign exchange market is when a firm has spare money to invest for short terms in another country based on the interest rate and the rate of return. Finally, Hill indicated that firms use foreign exchange market for currency speculation, which means the short-term movement of funds from one currency to another in the hope of profiting from shifts in exchange rates. Due to currency conversions, China has set a policy three years ago to protect its banks and investors from the worldwide financial crisis. China allows banks and companies to settle payments with cross-border trading partners in renminbi (RMB), meaning that a multinational corporation in U.S. can now pay a Chinese supplier in RMB, and a qualified Chinese buyer can pay a U.S. supplier in RMB. [Ryan \(2011\)](#) stated that foreign companies can accumulate the more freely tradable version of the Chinese currency informally called offshore RMB in bank accounts newly available in Hong Kong and elsewhere. He further stated that this type of transaction greatly benefits U.S companies, some of which have had to settle trades with Chinese suppliers in U.S. dollars. [Siddigi \(2007\)](#) stated that Africa's currencies unlike those of Europe and Japan seem to be stable as far as foreign currency conversions are concerned. African currencies are now more stable than they have been during the past decade. Unlike other emerging market regions, African exchange rates are governed by a set of variables. The main factors are capital flows which are foreign direct investment (FDI) and portfolio investments. He continued to emphasize that the external trade balance which are the differences between the value of exports and imports monthly or quarterly releases the economic data on GDP. Africa's exchange rate is strong, reflecting high inflation gaps with many trading partners in Western Europe, the United States and East Asia including China and Japan. Despite this positive outlook for economic prospects, there are a few downfalls that might challenge African currencies. The continent's export performance would suffer if global growth slows down, service prices fall and interest rates rise in the developed world. [Brigham and Ehrhardt \(2005\)](#) mentioned that foreign currency exchange

risk is the risk or variance of a firm's cash flows that may be attributed to currency fluctuations. This also affects travelers in reduction of their currency when converted in the bank or at the airport. Also Irwin (2011) expressed that international trade and monetary relations have certainly undergone more than one period of tension in the course of history, a reflection of their intertwined nature. After the recent financial crisis, as in previous periods of distress for the world economy, exchange rates are perceived to be a transmission belt of financial shocks to the real economy and a vector of "monetary dumping". Clark (1973) also mentioned the hypothetical case of a firm operating under perfect competition that produces a single product, which contains no imported input for sale in export markets. The firm is paid only in foreign currency; hence, the proceeds of its exports in domestic currency depend on the (unpredictable) level of the exchange rate.

3. RESEARCH QUESTIONS

3.1. Do Foreign Exchange Rates Uncertainty Reduce the Incentive of Travelers and Small Business Owners from Transacting Business Abroad?

Not directly, but the exchange rates uncertainty can have strong effects on the economy and can also reduce the number of travelers that travels abroad. It may also affect the structure of production output and investment for small businesses, which can lead to inefficient allocation of domestic absorption and external trade. Keythman (2015) mentioned that the most important aspect of currency conversion rates in relative to international business is that currency conversion rates have a direct effect on the numbers of goods a country can export or import from another country. For example, when the U.S. dollar is doing well, Americans demand more goods from abroad, because the dollar is able to buy more foreign currency and therefore more goods. When the U.S. dollar fluctuates in conversion rates, foreign goods became more expense, which reduces number of importations and causes U.S. citizens to buy made in America. On the other hand, when the dollar is doing poorly, it makes goods produced in the United States relatively cheap for other nations to buy, which in turn increases demand for U.S. goods and raises U.S. exports. In general, consumers benefit from a stronger dollar because they can buy more goods abroad, while producers often benefit from a weaker dollar since more customers abroad will demand their goods. Indeed, currency conversion has a huge effect on the market for international business person. On the other hand, when a traveler travels to a foreign country, the traveler must buy that country's currency in order to lodge in hotel, eat at a restaurant, and transact business, or visit other attractions. If the dollar is strong, the traveler can buy a lot of that country's currency, which will make traveling abroad cheaper. If the U.S. dollar is weak versus the currency of a particular country, the traveler might avoid traveling to the abroad and instill will travel to a different country that does not have such a strong currency. Similarly, a weak U.S. dollar will attract more travelers to the United States, since domestic prices will be relatively cheaper to other countries. Gordon (2015) says that currency conversion has become a big concern in many countries due to foreign exchange markets. Apparently, due to globalization, many corporations have created businesses and subsidiaries outside their home country, hence, larger percentage of activities are recorded in a foreign currency which makes the foreign exchange rate fluctuates. In addition each subsidiary has to meet the currency requirements of each country in order to keep its books and records in the country's currency where the assets are located.

3.2. Is it Necessary for Travelers and Small Business Owners to Understand the Relevance of Foreign Exchange Rates and Currency Risk Management?

In order to address this research question in a world of currency exchange rates market where one cannot predict the foreign exchange market and the movement of currency flows. It is imperative for small business owners and travelers to understand the relevance of foreign exchange rates and the currency risk management. The small business owners and travelers must understand the various variables that can influence foreign exchange rates such as the interest rates, commission rates, inflation rates, and price of goods in two countries. A small business person

can use hedging to protect its currencies, which means to insure against potential losses from adverse exchange-rate changes. Without doubt, the foreign exchange market provides insurance for business owners to protect themselves against foreign exchange risk. The possibility that unpredictable changes in future exchange rates will have adverse consequences on a firm, hence, a firm that insures itself against foreign exchange risk is hedging. In addition to hedging, small business owners or travelers should engage in forward exchange where two parties agree to exchange currency and execute the deal at some specific date in the future. The forward exchange rates transactions are typically quoted for 30, 90, or 180 days into the future. Another example of forward exchange that can be used by small business owners or travelers is known as a currency swap, which is the simultaneous purchase and sale of a given amount of foreign exchange for two different value dates. This form of transaction can protect the value of currencies. For example, currency swaps take place between international firms and their banks, between foreign banks, and between governments when they want to exchange one currency into another for a limited period without incurring foreign exchange risk. Another example is the arbitrage which means purchase and sale of a currency in different markets for profit, and speculation transaction which means the sequential purchase and sale or vice-versa of a currency for profit. To understand further the foreign exchange rates, the purchasing power parity (PPP) explains the relationship between prices of goods and exchange rates. The PPP indicates that under a floating exchange regime, a relative change in purchasing power parity for any pair of currency calculated as a price ratio of traded goods would tend to be approximated by a change in the equilibrium rate of exchange between these two currencies.

4. CLASSROOM DISCUSSIONS

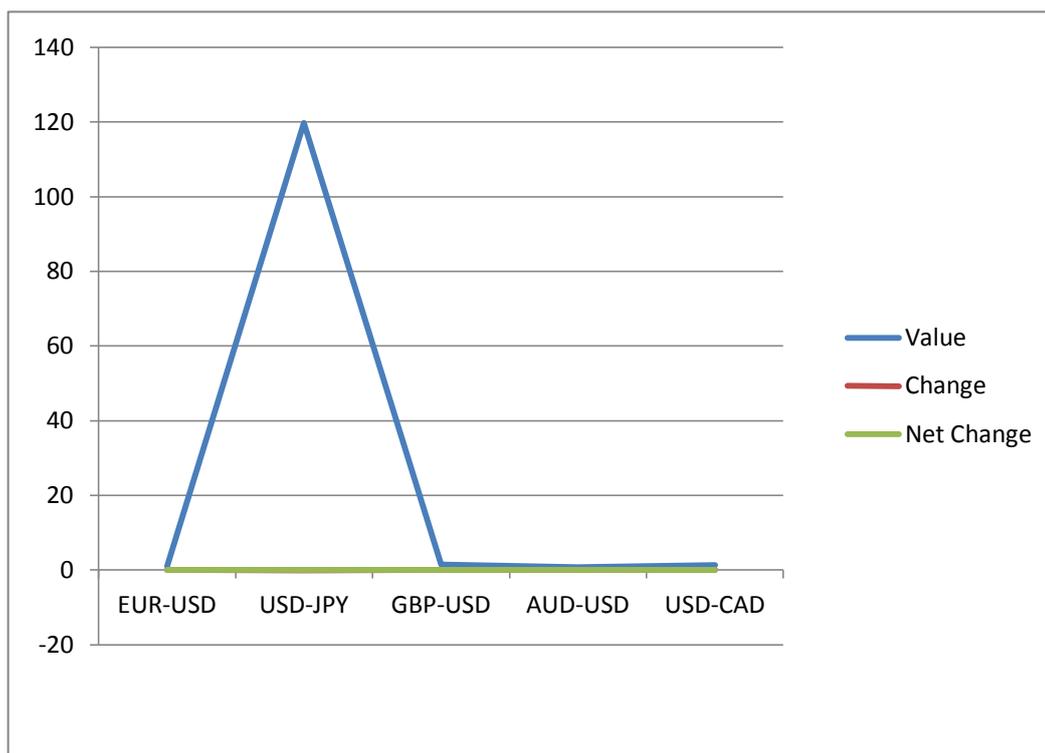
To make this study more interesting, international business students were encouraged to read at least two - four recent articles on currency conversion and to give their honest opinions on how currency conversion can impact business owners and travellers. Many of the students were amazed to understand how currency conversion can affect the price of goods and decisions of business owners and travelers. The students discussed how traveling to Europe might not be encouraging for travelers due to the value of the exchange rate or a business owner having a business operation in Europe, meaning that the business owner will not be able to make adequate profits because the workers have to be paid in euro currency. The students further discussed currency depreciation and its effect on exports; they indicated that the U.S. dollar varies for different foreign currencies and it fluctuates based on a number of factors. For example, if the U.S. dollar depreciates relative to a foreign currency, the exchange rate between the two countries' currencies rises. Meaning that it will be more expensive for a business owner in the U.S. to convert dollars to a foreign currency and cheaper for a foreign business to convert to dollars. The discussion went as far as quoting China's currency (renminbi) depreciation of 4.4% in (September 2015) against the U.S. dollar and making Chinese exports to be cheaper and imports into China more expensive. This means that U.S. exports to China will be very expensive due to the strong value of the U.S. dollar and a disadvantage to the U.S. because other countries will be glad to do business with China and vice versa.

Major World Currencies

Currency	Value	Change	Net Change
EUR-USD	1.1225	0.003	0.27%
USD-JPY	119.78	-0.15	-0.13%
GBP-USD	1.5193	0.0062	0.41%
AUD-USD	0.7023	-0.0007	-0.10%
USD-CAD	1.32	-0.0068	-0.51%

Source: Bloomberg.com

Major World Currencies in Graph



Major World Currencies in Graph

5. ADVANTAGES AND DISADVANTAGES OF CURRENCY CONVERSIONS

In the foreign exchange market there are merits and demerit of exchanging currencies among different nations therefore, a country can reduce risk in international trade by maintaining a fixed rate, whereby the small business owners and travelers doing business abroad can agree on a price and not be subject to the risk of changes in the current exchange rate before contracts are settled. This type of structure can encourage investment. With the help of fixed rates, the establishment of speculation will be eliminated. One has to keep in mind that speculation flows can be very demoralizing for an economy and the incentive to speculate is very small when the exchange rate is fixed.

There few demerits on fixed rates, the first demerit is that large holdings of foreign exchange reserves required a government to hold large scale reserves of foreign currency to maintain the fixed rate, such reserves have an opportunity cost. Secondly, fixed rates are usually unstable which means that countries within a fixed rate mechanism often follow different economic policies, the result of which tends to be differing rates of inflation. What this means is that some countries will have low inflation and be very competitive and others will have high inflation and not be very competitive. The uncompetitive countries will be under severe pressure continually and may, ultimately, have to devalue their currencies and speculators will know about devaluation of currency and thus creates further pressure on that currency.

6. METHOD OF ANALYSIS

The paper research methodology requires gathering of relevant data from various journals, articles, textbooks, and student's participation in international business course. The focus of the paper was primary on the relationship between currency conversions on international business transactions with small businesses and travelers. A research question was aimed to determine if (1) foreign exchange rates uncertainty reduce the incentive of travelers and small business owners from transacting business abroad and (2) if it's necessary for travelers and small

business owners to understand the relevance of foreign exchange rates and risks management. Consequently, these two questions were used to discuss the impact of foreign exchange rates and its risks. In addition, more recent literatures related to the topic of the paper were also used to base the findings of the paper.

7. RECOMMENDATIONS AND CONCLUSIONS

Businesses should look for the best currency specialists because managing your foreign currency effectively is an important requirement of any business that transacts internationally. Furthermore, small business owners or travelers should check the most up-to-date currency conversion or use the forward exchange rates, currency swaps, or speculation before they transact any businesses. There are many ways of finding out current currency rates, including searching in the currency conversion section of the internet, checking with a travel agency or banks. Another recommendation for travelers making purchases overseas is to use a credit card. The reason behind that is that credit card companies tend to negotiate the best rates and the most favorable conversions because they do such a high volume of transactions. These companies take out all the guess work for you, paving the way for smoother and probably less expensive transactions. In conclusion, travelers, investors and small business owners can take steps to mitigate risks and take advantage of such currency movements addressed in this paper. Currency conversions by all means impact and affect the performances or success and failures of small businesses in international transactions.

These success and failures invariably affect a nation's economy at large.

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