Difference Between Foreign Exchange Risk and Exposure

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Key Difference - Foreign Exchange Risk vs Exposure

Foreign exchange risk and exposure are two terms that are confused to be the same since they are often used interchangeably. However, their meanings are different in nature, though closely related. Foreign exchange risk and exposure are experienced by companies that have business operations in multiple countries. The key difference between foreign exchange risk and exposure is that **foreign exchange risk is the change of value in one currency relative to another which will reduce the value of investments denominated in a foreign currency** whereas **foreign exchange exposure is the degree to which a company is affected by changes in exchange rates.**

What is Foreign Exchange Risk?

Foreign exchange risk is the change of value in one currency relative to another which will reduce the value of investments denominated in a foreign currency. Three forms of foreign exchange risk are identified as per below.

Transaction Risk

Transaction risk is the exchange rate risk resulting from the time lag between entering into a contract and settling it.

E.g. Investor A, who is a resident in the UK is obliged to pay a sum of $ 15,000 to another individual as a part of an agreement in 6 months' time. The current exchange rate is £/$ 1.26. Since the exchange rates are subjected to fluctuations and the rate at the end of six months is unknown at present.

Translation Risk

Translation risk is the exchange rate risk resulting from converting financial results of one currency to another currency.

E.g. Company G's parent company is Company A, which is located in the USA. Company G is located in France and conducts trading in Euro. At the year end, results of Company G is consolidated with the results of Company A to prepare financial statements, thus the results of Company G are converted into US Dollar.

Economic Risk

Economic risk reflects the risk of the present value of future operating cash flows from exchange rate movements. Economic risk is concerned with the effect of exchange rate changes on revenues (domestic sales and exports) and operating expenses (cost of domestic inputs and imports).

E.g. Company C is a medium scale local business based in Country Y that sells wheat. Since the wheat production in the country is limited, wheat is also being imported from a neighboring country. Due to currency appreciation, imported wheat is cheaper. As a result, the demand for wheat in Company C is declining.

Figure 01: Foreign exchange risk is the change of value in one currency relative to another.

What is Foreign Exchange Exposure?

Foreign exchange exposure refers to the degree to which a company is affected by changes in exchange rates. When a company is engaged in international trade and when there is a difference between the currency in which revenues and costs are recorded, a foreign exchange exposure exists.

Impact of Imports and Exports

Imports and exports are two elements that are heavily affected by foreign exchange exposure. When the exchange rate appreciates (value of home currency increase in relation to a foreign currency), it is beneficial to import more goods and services. On the other hand, when the exchange rate depreciates (value of home currency decreases in relation to a foreign currency) country's products are cheaper in the international market; this is favorable for exports.

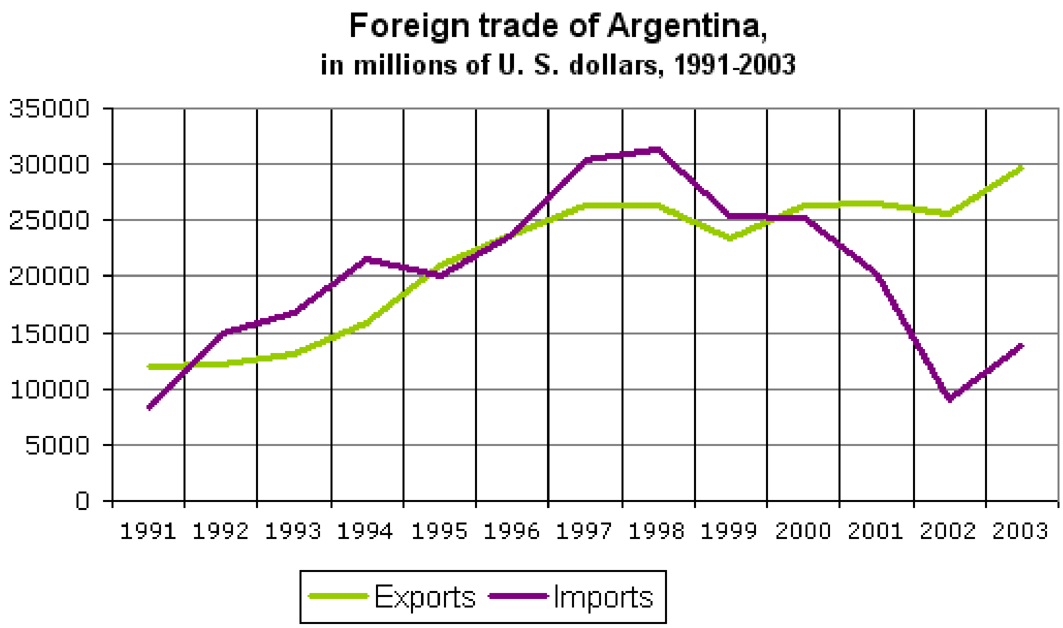

Figure 02: Imports and exports

Manufacturing Products in Home Country and Selling in Multiple Countries

Some companies adopt this strategy in order to take advantage of economies of scale (reduction in costs as a result of an increase in the volume of production). Further, a single manufacturing base is more convenient to manage compared to several ones. In this case, the costs of production are incurred in home currency whereas revenue will be incurred in multiple currencies. Due to this mismatch of revenue and costs, the companies are open to foreign exchange exposure

What is the difference between Foreign Exchange Risk and Exposure?

Foreign Exchange Risk vs Exposure	
Foreign exchange risk is the change of value in one currency relative to another which will reduce the value of investments denominated in a foreign currency.	Foreign exchange exposure is the degree to which a company is affected by changes in exchange rates.
Control	
Foreign exchange risks can usually be mitigated through the use of hedging techniques and using a less volatile currency to report results.	Foreign exchange exposure is difficult to manage.
Types	
Transaction, translation and economic risk are types of foreign exchange risks.	Risk exposure due to imports and exports are main types of foreign exchange exposure.

Summary- Foreign Exchange Risk vs Exposure

The difference between foreign exchange risk and exposure is that foreign exchange risk is the change of value in one currency relative to another which will reduce the value of investments denominated in foreign currency while foreign exchange exposure is the degree to which a company is affected by changes in exchange rates. Overall, both concepts are much similar in nature as they demonstrate the relative profit or loss due to engaging in transactions in various currencies.

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