JOURNAL OF ENGINEERING annals OF FACULTY OF ENGINEERING HUNEDOARA

MODERN FINANCIAL INSTRUMENTS IN SMALL BUSINESSES

[1,2,3]Miriam PEKARČÍKOVÁ, Renáta TURISOVÁ, Zuzana HAJDUOVÁ

[1,2]Technical University of Košice, Faculty of Mechanical Engineering, Department of Management and Economics, Košice, SLOVAKIA
[3]University of Economics in Bratislava, Faculty of Business Administration in Košice, Department of Business Informatics and Mathematics, Košice, SLOVAKIA

ABSTRACT:
From the end of 70-ties of the 20th century, the growing volatility of exchange rates accelerated the need and creation of new instruments for protecting against this phenomenon. One category of these new instruments includes financial derivatives.
Financial managers are often updating their knowledge and skills, because economical markets, laws, administrative regulations and information technology are continuously and rapidly changing and dynamically evolving.
KEYWORDS:
Bussines, instruments, bussines risks, technologies

1. INTRODUCTION

In the current, open business environment, Slovak businesses are forced to make financial decisions as a reaction to business risks, which in turn are influencing their operations. For Slovak businesses, the transition of the Slovak currency to the floating exchange rate in October 1998 evoked a need to protect themselves against exchange rate risks.

Additionally, financial markets in the last decades passed through a more intense development. One of these innovations includes financial derivatives, which are accessible also for small businesses. An expressive expansion of innovative information technologies makes it possible even for small business to make speculative trading or effective hedging operations by the means of trading platforms.

2. BUSINESS RISKS

A business entity operating in an international trade is confronted with risks, which are not involved when operating only at domestic markets. Foreign economical relationships include higher risk compared to domestic economical relationships. The creation of various instruments for minimizing these risks, which need not to be used in domestic economy (whether these instruments are represented by a specific shipping or payment conditions, or financial instruments used for minimizing risks), may be regarded as an evidence for the existence of these higher risks[7]. The growth of these risks was evident mostly in 80-ties of the 20th century, which further accelerated the development and the use of modern financial instruments like derivatives.

Businesses are facing economic risk, which involves extensive field of possible impacts of changing exchange rates on the competitiveness and the overall value of businesses. The elimination of economic risk is first of all a matter of strategic measures. From the long term perspective, businesses have to adapt their purchasing, manufacturing and pricing policy. Critical indicators are: life cycle of the product on a foreign market, product portfolio,

competitive and market position. Further on: inflation, risks coupled with monetary and fiscal policy and a significant elements of these risks are risks coupled with foreign-trade operations. The inflation risk functions together with exchange rate risk, because higher inflation rate in a system of floating exchange rates leads to lower exchange rates, which in return yields increased prices for imported goods. Before actually realizing a business plan, the basic task of an entrepreneur is to define economic risk, especially in the current environment of globalizing environments [15].

An important part of economic risk is currency risk. This risk may be defined as the risk of changing spot exchange rates, or their volatility [3]. In a case of an exchange or currency risk, it is the negative development of currency risk, more precisely the negative development of instruments sensitive to the changes of exchange rates[5].

The entrepreneur is risking, that his trades will be affected by the future exchange rates. That is why this risk is referred to as exchange rate risk. For example, a Slovak exporter who is exporting to the foreign countries, receives a paid off invoice only after few months, after actual export of the goods. If during this time the Slovak currency appreciates or depreciates compared to a foreign currency, he will gain an additional profit or simply suffer a loss.

The reduction of business risks is practically carried out through two approaches. Either the risk factors are eliminated or reduced, or negative outcomes are minimized. Currently, protecting against risks is possible through various ways. Even if we are not fully able to eliminate risk (first of all the systematic or market risk), by the means of suitable steps, we can achieve mitigation or elimination of unsystematic risk. For this activity, reaching profit is a secondary objective.

Three basic concepts for mitigating risk are:

1) insurance,
2) management of assets and liabilities,
3) hedging.

The third concept of mitigating and eliminating risk is a form of reinsuring – hedging. The principle of active management of currency positions is observation of individual assets and liabilities denominated in foreign currencies and the observation of relationships among them. These assets and liabilities are forming short or long positions, which need to be reinsured on futures market. According to the position and the development of the market, it is possible to make a decision, whether it is necessary to reinsure the resulting position or not.

3. INNOVATIVE INFORMATION TECHNOLOGIES

Online trading represent trading activities, where the trader is giving direct orders through communication channels, e.g. internet. This process is mostly fully automated and interconnected to the centre of the trading system. More importantly, these online systems let us say financial instruments are using margin trading models. Trading platforms allow trading on the principle of a financial leverage with an ability to make easy real time settlements.

Nowadays small and medium sized enterprises can react to exchange rate changes through modern flexible technologies. The development of information technologies brings new possibilities for entering off-board OTC market and financial managers can themselves realize hedging operations through online trading platforms.

Trading with forex based instruments of an off-board market makes it possible to entry a highly liquid market, which brings good trading opportunities and a wide offer of currency pairs. Traders can trade long and short positions (buy and sell) 24 hours a day the required currency pair, using cca. 1% margin requirement. This means, that to open a position one needs only a fragment of the real sum needed on physical market, while the trader, or hedger has the possibility to achieve the same profit or loss. Through internet connection and a computer, the manager has real time exchange rates for spot and future contracts. The trade is realized through simply mouse click – by giving a trading order.

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4. RECOMMENDATIONS FOR SMALL BUSINESSES

In this section we provide recommendations for financial managers of small businesses, with regard to the use of trading platforms as an application for hedging purposes. We present in a structured way pros and cons, or requirements needed for small businesses when using innovative modern means for hedging. The hedging for small businesses using a trading platform brings following advantages:

1) competitive spreads,
2) competitive margins and low trading volumes,
3) forex trading without tariffs,
4) 24-hour trading on a forex market, backoffice and technical support,
5) integrated tools for decision support,
6) reliability from experiences[18].

Competitive spreads - new trading platforms permit in-between brokers to make trades through internet (it is still possible to assign orders via phone). This allows them to offer very low pricing spreads. The important thing is that spreads does not depend and therefore does not change in dependence on the trading volume.

The competitive margins and minimum trading volumes - online trading platforms offer competitive margins. Margin is usually set to 1 – 10% from the trading volume. The minimum amount for hedging purposes is 10 000 USD, or the equivalent amount in different currency. Hedging through margin products allows more effective use of capital, because for reinsuring a trade one needs only a fraction from the overall position and therefore this financial leverage brings high investment profitability – ROI (Return on Investment).

Forex trades without payments – trading platforms usually offer trading without tariffs and allow continual 24-hour trading with prime currencies. Available are many cross-currency combinations of all most liquid currencies. 24-hour back office and a technical support - most in-between companies offer continual full technical and back office support (Backoffice is responsible for administrative operations related to client (customer) accounts, like: opening an account, realizing trades etc.)

Integrated tools for decisions - new technologies allow an access to the currency trading system in real time right from the financial's officer office. Trading platforms provide their users and clients with many free trading tools, which offer up-to-date trading prices, various types of commands, professional packages for graphical representation of the price and trends, offer information and news about event related to financial markets.

Reliability from experiences – the possibility to trade through Forex and an online trading platform in the western European and USA markets has its tradition for the past 10 - 15 years. Because the competition for the costumer is also an issue when it comes to the software which supports trades it is continuously developed and improved. There are numerous high quality software which are enabling online trading in order to speculate or to hedge, and which are situated in particular residential languages.

Now, we will present requirements imposed on a small business, which is interested in hedging their positions in foreign currency:

1) make a request for opening a trading account for hedging purposes and submit required documents,
2) deposit cash needed to open an account,
3) one personal computer (PC) for hedging purposes,
4) high quality internet connection,
5) educated and experienced financial manager (the most important requirement).

Prior trading experiences of the financial manager are imperative and one of the requirements to open a trading account.

Hedging is realized through information technologies i.e. using a computer and internet. A common computer is usually sufficient for trading purposes. It is recommended, that this computer should have at least 256 MB, or better 512 MB and more from the random access memory – RAM. Higher requirements are put onto high quality internet connection. Using a connection through modem or a dial-up connection is not recommended. The most suitable connection is one, using a DSL wire, or a guaranteed microwave connection.

Using a trading platform and especially the decision to realize a hedging, brings with it self additional and basically the most important demands on human resources of the company, and this is in fact more important for small businesses. For a small business the requirement to have an educated financial manager is probably the biggest obstacle for starting hedging operations.

The work with a trading platform is not demanding and even an averagely computer literate can master this software in no time at all. However, the employee which should be responsible for trading on Forex markets should have the required knowledge, experience with the foreign exchange markets, practice with hedging and at least a university degree in economics related studies.

5. CONCLUSION

Financial managers are often updating their knowledge and skills, because economical markets, laws, administrative regulations and information technology are continuously and rapidly changing and dynamically evolving. In order to be in touch with this development, managers should attend seminars, courses and lectures and continually educate themselves in their field of studies. The employers should and they often do, finance these educational activities for their financial managers.

It is the issue of businesses whether, they will invest into education activities of their financial managers and buy the required computer technologies used for modern innovative technologies used for hedging exchange rate risk, or they will add exchange rate losses into costs, reduce investment resources and so threaten their position and in matter of fact, also their existence on the market.

Article is published in cooperation with *VEGA č. 1/0052/08*.

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