CASE 18.1
Ups and Downs: A Foreign Exchange Simulation Game

Instructor Notes

The purpose of this simulation game is to make students become aware of the importance of the financial aspect of international business. The game is beneficial in forcing students to read newspapers and to consult financial data in order to track the movement of the U.S. dollar which affects corporate profits. Students will learn that what appears to be deceptively simple may not be so. They will realize that it is not so easy to guess the direction, speed, and extent of the exchange rate movement.

The game is desirable because it forces students to make business decisions which will either preserve or erode their profit derived from selling their products overseas. The student must consider the hedging method and the cost and complexity involved. It is easy to use futures or options for hedging purpose due to liquidity and low costs, but neither one of them will offer a perfect hedge. Naturally, more than one contract for each currency is required in this case. The cash and forward markets, in contrast, offer a customized contract--but at a higher cost.

It should be noted that the Japanese yen and the German mark tend to move in tandem against the U.S. dollar--although not necessarily at a uniform rate. In any case, if there is a need to hedge the Japanese yen, there is in all likelihood also a need to hedge the German mark and vice versa. If any student or group hedges just one currency and not another, the instructor may want to press the student to justify his or her decision.

One potential problem with this simulation game is that the two-week period may be too short for any significant exchange- rate movement, especially during the time period which the market happens to be relatively calm and stable. This, of course, may give students the wrong impression that hedging is wasteful and unnecessary.

One way of solving the problem is to start the game sooner. In order to lengthen the game, it requires that the chapter be taught earlier in the semester.

Another method is to use historical data for simulation purpose. The instructor may want to select several two-week periods from the past few years which had a significant rate movement. This method is desirable because it forces students to think whether they should hedge or remove their hedge as the market turns against them. It will make students realize that two weeks are more than adequate for the exchange-rate movement to erode or wipe out their business profits.