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The Effect of Foreign Exchange Volatility on Letters of
Credit: Cost and Profit
(An Empirical Study on Jordan)

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Spring 2009/2010

This thesis is submitted in a partial fulfillment of the requirement for
the degree of Master of Banking and Finance in Department of
Banking and Finance, Faculty of Economics and Administrative
Sciences, Yarmouk University, Irbid, Jordan
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Chapter One

Introduction

1-1 Preface

1-2 Study Objectives

1-3 Importance of the Study

1-4 Problem Statements

1-5 Study Limitations

1-6 Justifications for the Selected period

1-7 Study Methodology

1-8 Structure of the Study
Chapter One

Introduction

(1-1) Preface

There is a paramount importance for the letters of credits in financing and executing international trade. It requires knowledge and experience in the accurate and continuous aspect of professional work. Banking credits are an essential tool for foreign trade and its importance has emerged in Jordan, due to the growing volume of foreign trade in Jordan and the contribution of banks in financing foreign trade operations.

On the other hand, changes in the foreign currency exchange rates have a number of positive and negative effects and results. Letters of credit are subject to these changes and result in increasing/decreasing cost of funds. Currency exchange rates lead to changes on the cost of these appropriations and therefore change the profitability of the importer. As the high exchange rates lead to high cost of credit and therefore, lower profitability of the importer.

(1-2) Study Objectives

The purpose of the study is to achieve the following objectives:

1. Clarify the subject of letters of credit in general and explain its benefits and costs in particular.
2. Determine the patterns of exchange rates volatility in Jordan.
3. Measure the effect of exchange rates volatility on the costs of letters of credit in Jordan.
4. Estimate the effect of exchange rates variation on the profitability of letters of credit in Jordan.

5. Examine the effect of fixing the Jordanian dinar exchange rate against the US $ on the cost, profitability, and stability of letters of credit.

(1-3) Importance of the Study

This study receives its importance from the fact that it’s among the very few studies that investigate the relationship between letters of credit and foreign exchange rates volatility of the JD against the hard currencies, and against one not-hard currency.

In fact, to the best of my knowledge, this study is the only one in its subject in the Jordanian and Arabic literature.

Thus, the importance of this study stems from the lack of studies in this field. It is therefore hoped that this study will fill these shortages.

Finally, the importance of this study lies in providing methods and procedures that are possible to reduce the impact of changes in the exchange rates of foreign currencies to make a documentary with negative allotment balances. Therefore, this will lead to increase the effectiveness of the management of negative allotment balances through documentary letter of credit.

(1-4) Problem Statements

This study will try to answer the following questions:

1. Is there any effect of foreign exchange changes on letters of credit?
2. How these effects can be measured?
3. What are the implications of these impacts and that relationship?
4. Is there a relationship between changes in foreign exchange rates and changes in the documentary letter of credits cost?
5. Is there any relationship between changes in foreign exchange rates and profitability of negative allotment balances documentary?
6. What are the changes that have occurred on the movement of major foreign currencies over the past years?

(1-5) Study Limitations
1. This study is limited in terms of its sample.
2. There are no previous studies directly related to the subject of this thesis.

(1-6) Study Hypotheses
We can finalize the study hypotheses in the followings:

Hypothesis (1):
- **H0:** There is no significant relationship between the volatility of foreign exchange rates ($, €, £, AED) and change in cost of letters of credit.
- **H1:** There is a significant relationship between the volatility of foreign exchange rates ($, €, £, AED) and change cost of letters of credit.

Hypothesis (2):
- **H0:** There is no significant relationship between the volatility of foreign exchange rates ($, €, £, AED) and changes in profitability of letters of credit.
• **H1**: There is a significant relationship between the volatility of foreign exchange rates (\$, \€, £, AED) and changes in profitability of letters of credit.

**Hypothesis (3):**

• **H0**: Determining specific global currency by fixed exchange rate is not reducing from the effect volatility of exchange rates on letter of credit.

• **H1**: Determining specific global currency by fixed exchange rate is reducing from the effect volatility of exchange rates.

**1-7) Study Methodology**

This study will be using the quantitative analysis using of financial statements and reports.

So this study used the Simple Linear Regression Analysis as follows:

The volatility of the foreign exchange rate considered as an independent variable, where the costs and profit of letters of credit considered as dependent variables.

Cost = f (exchange rate), and sometime Profit = f (exchange rate).

Simple Linear Regression Analysis formula:

Regression Equation $Y_t = a + bX_t + \epsilon_t$

Because of the difference measurement unit between the dependent and independent variable (letters of credit and foreign exchange rate), we used the natural logarithm to avoid the problems of data type differentiation, also to be have the a statistical logical result for letters of credit values. So the linear equation will be as follows:

$\log Y_t = a + b \log X_t + \epsilon_t$
Where:

X: exchange rates of each of the currencies.
Y: cost or profit of letters of credit.
b: is the slope of the regression line (coefficient).
a: constant term.
t: time period of study (2005-2008).

(1-7-1) Justification for the Selected Period

The researcher selected this period (2005-2008), due to:

1. the increasing number of companies using documentary credits, especially the public shareholding companies, from 14 companies during the period (2001-2004) to 99 companies during the period of study (2005-2008)\(^1\)

2. Globalization and entering new market is one of reason that pushes the companies to use letters of credit.

(1-7-2) Data and Information Sources

Data are collected from the following secondary sources:

- The Central Bank of Jordan.
- Jordan government websites, such as (www.cbj.gov.jo).
- Many previous researches and different papers related to the study.
- Many books related to the study.

\(^1\)www.ced.gov.jo
(1-7-3) Population and Sample

The researcher uses industrial and commercial firms in Jordan as a case study to examine the impact volatility of the exchange rates of letters of credit by using the quantitative analysis. Population of the study consists of all commercial and industry firms. While the sample consists of five Jordanian firms selected randomly and four foreign exchange rates, £, €, $ as hard currencies, and AED as a soft currency.

(1-8) Structure of the Study

The structure of the study is organized as follows: Chapter 1, introducing the thesis. Chapter 2 reviews the related literatures. Chapter 3 provides a background about exchange rate and letter of credit. Chapter 4 is devoted to the data and methodology used in this study. The empirical results and analysis are reported in chapter 5. Finally, chapter 6 concludes the study and provides recommendations.

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The researcher did not mention the names of companies for the purpose of maintaining confidentiality.