



FAST FACTS 2007



FOREIGN EXCHANGE & CURRENCY

Exchange rates represent the linkage between one country and its partners in the global economy. They affect the relative price of goods being traded (exports and imports), the valuation of assets, and the yield on those assets. Since 1973 rates have been flexible. Foreign exchange markets determine these rates based on trade flows, interest rate differentials, differing rates of inflation, and speculation about future events. The VEDP advises that a minimal knowledge of spot exchange rates and currency markets be acquired prior to signing any final international sales contract.

SPOT EXCHANGE RATES

Spot exchange rates represent the value of one currency in relation to another at a given time. Values fluctuate in response to many variables.

Like the stock market, currency spot values are determined by supply and demand, which are influenced by political and monetary policy, expectations, and imports and exports. Countries with high inflation rates (which tend to yield lower investment) and countries with large trade deficits (which reflect high imports and thus high supplies of foreign currency) should eventually experience currency depreciation. (U.S. Federal Reserve)

Example: Per the chart on the right it “cost” 2.15260 Reals to buy one USD\$ on August 21, 2006. One year later it cost 2.02925 Reals to buy one USD\$. Thus the Dollar is depreciating and the Real is appreciating vis-à-vis the Dollar. The U.S. Dollar is depreciating against all currencies listed to the right except the Argentine Peso, Hong Kong Dollar, Mexican Peso, Singapore Dollar, and the South African Rand.

FOREX Demand: From a U.S. perspective, demand for foreign currency (FOREX) is primarily influenced by demand for imports or U.S. investment abroad.

Example: A purchase of Brazilian goods or U.S. investment in Brazil. The U.S. buyer sells US\$ to bank and buys Reals to pay Brazilian seller for imports. This creates a demand for Reals. The Dollars are converted at the bank to buy Reals in order to make payment for imports or investment in Brazil. Over time, this leads to Dollar **depreciation**.

Spot Currency Rates 1 USD\$ =	8/21/06	8/21/07
Australian Dollar	1.31777	1.25141
Argentine Peso	3.08440	3.16575
Brazilian Real	2.15260	2.02925
*British Pound	.53167	.50424
Chilean Peso	554.890	523.250
Czech Koruna	21.97599	20.45700
Canadian Dollar	1.12609	1.05965
Chinese Yuan <small>US\$ peg partially removed July 21, 2005</small>	7.98550	7.59945
*European Euro	.78006	.74155
Indian Rupee	46.46500	41.08169
Hong Kong Dollar	7.77521	7.81603
Japanese Yen	115.838	114.704
Jordanian Dinar	.71360	.71346
Mexican Peso	10.83340	11.09678
Polish Zloty	3.05623	2.85210
Russian Ruble	26.74181	25.77526
Saudi Riyal	3.75130	3.75121
Singapore Dollar	1.57450	1.52747
S. African Rand	6.94000	7.37744
S. Korean Won	973.805	945.001
Swiss Franc	1.23379	1.20683
New Turkish Lira	1.46100	1.35444
U.A.E. Dirham	3.67400	3.67320



FAST FACTS 2007



FOREIGN EXCHANGE & CURRENCY

US\$ Demand: From a U.S. perspective, supply of foreign exchange is primarily influenced by supply of exports and foreign investment in the U.S. This creates demand for Dollars at the bank because payment or investment is made in U.S. Dollars.

Example: A sale of U.S. goods to Brazil or Brazilian investment in the U.S. The Brazilian buyer sells Reals to bank and buys US\$ to pay U.S. seller for exports. This creates a supply of foreign currency at the bank because the Real is converted to make Dollar payments or investments. Over time, this leads to Dollar **appreciation**.

Note: The British Pound and the Euro * are reciprocals. Exchange rates can be expressed as the foreign price of a domestic currency or its reciprocal- the domestic price of foreign currency. (Source for chart on preceding page: www.oanda.com)

HOW DO EXCHANGE RATES AFFECT IMPORTS & EXPORTS?

As exchange rates fluctuate, the domestic prices of foreign goods will often be affected.

If the US\$ **depreciates** vis-à-vis a foreign currency, U.S. exports become cheaper and tend to rise, while U.S. imports theoretically become more expensive and tend to fall.

Example: The stronger Brazilian Real (it now takes less Real to buy a U.S. Dollar) or weaker U.S. Dollar (a Dollar now buys fewer Real). This relationship makes Brazil's goods exported to the U.S. more expensive to buy with U.S. Dollars. At the same time, it makes goods that the U.S. exports to Brazil more affordable to buy with Real. We would expect that this change would lead to an increase in the flow of goods from the U.S. to Brazil

Conversely, if the US\$ **appreciates** vis-à-vis a foreign currency, U.S. exports become more expensive and tend to fall, while U.S imports become cheaper and tend to rise.

Example: A weaker Mexican Peso (it now takes more Pesos to buy a U.S. Dollar) or stronger Dollar (a Dollar now buys more Yen); this relationship makes Mexico's goods exported to the U.S. less expensive to buy with U.S. Dollars. At the same time, it makes goods that the U.S. exports to Mexico more expensive to buy with Pesos. We would expect that this change will lead to an increase in the flow of goods from Mexico to the U.S.

The exchange rate process is complicated for money brokers, but it doesn't have to be for the average exporter. A brief synopsis of how exchange rates are used by an exporter is printed below. This synopsis was taken from The Basic Guide to Exporting, a publication of the U.S. Department of Commerce in Cooperation with Unz & Co., Inc.

"A buyer and a seller who are in different countries rarely use the same currency. Payment is usually made in either the buyer's or the seller's currency or in a third mutually agreed-upon



FAST FACTS 2007



FOREIGN EXCHANGE & CURRENCY

currency. One of the risks associated with foreign trade is the uncertainty of the future exchange rates. The relative value between the two currencies could change between the time the deal is concluded and the time payment is received. If the exporter is not properly protected, a devaluation or depreciation of the foreign currency could cause the exporter to lose money.”

Example: *If the buyer has agreed to pay 1,000,000 Yen for a shipment and the Yen is valued at 100 Yen per Dollar, the seller would expect to receive US\$10,000. If the Yen later decreased in value to be worth 99 Yen per Dollar, payment under the new rate would be only US\$9,900, a loss of US\$100 for the seller. On the other hand, if the Yen increases in value to 101 per Dollar the exporter would get \$10,100 an extra \$100 in profits.*

Most exporters are not interested in speculating on foreign exchange fluctuations and prefer to avoid risks. One of the simplest ways for a U.S. exporter to avoid this type of risk is to quote prices and require payment in U.S. Dollars, thus placing the burden of exchanging currencies and associated risks on the buyer. Exporters should also be aware if there are problems with currency convertibility. Not all currencies are freely or quickly converted into US\$. Fortunately, the US\$ is widely accepted as a global trading currency and U.S. firms can often secure payment in Dollars.

If the buyer asks to make payment in a foreign currency, the exporter should consult an international banker before negotiating the sales contract. Banks can offer advice on the foreign exchange risks that exist with a particular currency. Some can also help hedge against such a risk, by agreeing to purchase the foreign currency at a fixed price in Dollars, regardless of the currencies value at the time the customer pays. Banks normally charge a fee or discount the transaction for this service. If this mechanism is used, the bank's fee should be included in the price quotation.

MITIGATING FOREIGN EXCHANGE RISK

While getting paid in United States Dollars is preferred, it is not always possible. In the example above, risk arises in terms of potential losses to the buyer or seller due to fluctuations in the value of the Yen. These risks can be minimized through “hedging”.

- Hedging minimizes the risk for both the buyer and the seller.
- Without hedging, the U.S. exporter absorbs the risk if the foreign currency depreciates and the buyer absorbs risk if it appreciates.
- Hedging protects against major downside losses by securing future currency values.
- Hedging is needed for all sales without advance or U.S. Dollar payments.
- Hedging is offered by banks for a fee which can be added to the final contract.

Hedging Example: *U.S. exporter sells goods valued at \$100 to be paid for with Yen. In currency terms this sale equals **Sell Yen-Buy Dollar**. Today's rate is 100 Yen per U.S. Dollar, but the terms call for payment one month from now and the Yen is projected to appreciate vis-à-vis the Dollar to a rate of 99 Yen per U.S. Dollar. The seller needs to be paid \$10,000, not \$9,900. In order to ensure payment of \$10,000, a counter “hedge” would be placed to offset this risk of loss.*



FAST FACTS 2007



FOREIGN EXCHANGE & CURRENCY

In summary, exchange rates, if not carefully considered, can dramatically change the anticipated outcome of a foreign contract. When dealing with large contracts, exporters should always consider currency exchange risk and use one of the above methods to mitigate any losses due to currency fluctuations. While this document does not present all the various ways to cover currency risk, some key types of hedging are listed on the following chart.

TYPES OF HEDGING			
Type	How it Works	Cost	Other Comments
Forward Contracts	(easiest/ safest method) Bank's FOREX dept. or correspondent bank guaranties value of foreign currency at future date.	Variable depending on risk of FOREX. Exporter buys/pays "premium" or "discount"	Best for small exporters with good credit. Requires collateral/credit line equal to 25% of contract price to cover bank risk.
Forward Window Contract	Bank offers same forward contract but for an undetermined date or "window"	Higher than Forward Contract due to higher risk for bank.	Used when exporters contract signing date is not certain.
Options	Exporter buys the right to purchase a foreign currency at a specific price but is under no obligation to do so.	Payment is up-front and is expensive.	This is similar to buying insurance. However, it allows more safety.
Futures	Similar to forward contracts but transacted by currency commodity brokers. They have specific call dates once each quarter: March, June, September, and December.	Exporter keeps a margin account with commodity broker. Usually one to two percent of contract value. If foreign currency appreciates, margin costs go up.	Only done in major currencies. Usually for transactions over \$75,000.
Swaps	Provided by large currency exchange bankers. Exporter agrees to "swap" currency at certain time and date. Many other contractual items added to meet exporter's needs.	Highest cost of all methods. Involves extensive paperwork. Used for complicated export transactions.	
Working capital Loan	Issued by your banks correspondent bank overseas. Foreign buyer pays in their currency and U.S. exporter exchanges in U.S. dollars anytime it becomes advantageous.	Not available in developing countries.	Need good credit and collateral.

(Source: The Export Institute)



FAST FACTS 2007



FOREIGN EXCHANGE & CURRENCY

VEDP TRADE EVENTS

For a complete listing of VEDP's international trade events, please visit the "Events" tab on our website: www.ExportVirginia.org

VEDP CONTACT INFORMATION

Virginia Economic Development Partnership

Division of International Trade

P.O. Box 798

901 East Byrd Street

Richmond, Virginia 23218-0798

Tel: (804) 545-5764

Fax: (804) 545-5751

E-mail: ITR@yesvirginia.org

Website: www.exportvirginia.org

ADDITIONAL RESOURCES

- Exchange Rates: <http://www.x-rates.com>
- The Currency Site: <http://www.oanda.com/convert/classic>
- Your Bank

International Banking Contacts:

Dewey M. Chester, Jr. BB&T, International Services Division

www.bbandt.com/international/ 804-787-1315 dchester@bbandt.com

Knox Hubard Bank of America

www.BankofAmerica.com (804) 788-2120 knox.hubard@bankofamerica.com

Marsha Sompayrac SunTrust Bank

www.SunTrust.com (804) 782-5558 marsha.sompayrac@suntrust.com

WORKS CITED

Humpage, Owen F., <www.clevelandfed.org>

Federal Reserve Bank of Cleveland. January 1, 1998 22 Aug.2003

<<http://www.clev.frb.org/research/com98/0101.pdf>>

India Infoline Ltd., "Features: Understanding U.S. Markets: Foreign Exchange." October 14, 2000. 22 Aug. 2003 <<http://www.indiainfoline.com/>>

Jagoe, John R. Export Sales & Marketing Manual 2001. 14th Ed. Export Institute. 2001. 15th Edition Available at: <<http://www.exportinstitute.com>>

United States Department of Commerce and Unz & Co., Inc., A Basic Guide to Exporting™ 1998. 26 July, 2004 <<http://www.unzco.com/basicguide/toc.html>>

Last Revised: August 2007

**Information provided by VEDP Fast Facts is intended as advice and guidance only. The information is in no way exhaustive and the VEDP is not a licensed broker, banker, shipper or customs agency. VEDP shall not be liable for any damages or costs of any type arising out of, or in any way connected with the use of, these Fast Facts.*