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Exchange Rates and Manufacturing

Amicus Guide

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INTRODUCTION

This guide to Exchange Rates and Manufacturing provides an overview of exchange rates: what they are, what they do and some issues relating to business and manufacturing. This includes basic information on the risks of exchange rate fluctuations and dealing in foreign currencies and also some implications of trading with EU countries.

It is not an exhaustive document and you should contact your workplace representative or full-time officer for detailed queries on this issue.

The guide has been drawn up by the Union's research department with reference to the Department of Trade and Industry, The Bank of England, Business link, and HM Revenue and Customs websites. A list of useful websites is provided at the end of the guide.

■ WHAT IS AN EXCHANGE RATE?

Exchange rates are familiar to anyone who has been on holiday abroad. If you travel from a country where the pound sterling is legal tender to a country where, e.g. the US dollar is legal tender, you will need to exchange pounds for dollars, and so you will need to know how many dollars you will get for each pound.

An exchange rate is simply the price of a unit of currency used in one country or area expressed in the money of another country or area. This can be achieved by one of the following three methods:

Direct quotation

As someone living in the UK, the price of each unit of foreign currency could be expressed in terms of the home currency, sterling. So, using the exchange rates at 12 July 2006 we could express the US dollar and euro exchange rates respectively as:

£0.546 = $1 £0.692 = €1

Indirect quotation

We could also express the value of each pound sterling in terms of the dollar or the euro:

$1.833 = £1 €1.444 = £1

Cross exchange rate

A cross exchange rate is the value of one foreign currency expressed in another. For example, we can deduce from the above figures that if $1.833 and €1.444 are both worth £1, then:

€1 must be worth $1.268 $1 must be worth €0.788

■ WHY EXCHANGE RATES MATTER

British holidaymakers travelling to the US hope that sterling strengthens against the US dollar. They will then get more dollars for each pound sterling they exchange, and will be able to buy more goods in the US.

However, someone seeking to sell dollars and buy sterling will hope that sterling weakens against the dollar. The US dollars that he or she holds will then become more valuable in sterling terms. For example in December 2005 the dollar had strengthened against sterling compared to January of that year. At 4 January 2005 the exchange rate was $1.8835 = £1. At 30 December 2005 the rate was $1.7184 = £1. This meant that $1,000 could be exchanged for £531 at the beginning of January but the same amount of dollars could be exchanged for £582 at the end of December.

The same principle applies to companies. If sterling strengthens against a particular foreign currency – e.g. the US dollar – the company will get more foreign currency for each pound sterling, in other words each £1 sterling is worth more in US dollar terms.

A company may export parts to the US, selling the parts to a US retailer for £75 each, but if sterling strengthens against the US dollar, that £75 is worth more in terms of US dollars. The retailer may increase the price charged to the end customer, so that fewer parts are sold; or they may pressure the UK company to lower its price, thus squeezing the UK supplier's profit margin; or they may cancel the order entirely. In any event, the UK company's competitiveness in the US market is reduced.

Moreover, if sterling strengthens against the dollar, any parts imported from the US into the UK will be cheaper in

sterling terms. So although the UK company may gain some benefit through lower costs, it is also likely to face increased competition in the domestic market.

If sterling weakens against the US dollar, the effects are reversed. The competitiveness of exports to the US increases, while imports from countries using the US dollar become less attractive.

■ EFFECT OF EXCHANGE RATES ON THE VALUE OF ASSETS AND LIABILITIES

Fluctuations in exchange rates will also affect the value of any assets or liabilities expressed in a foreign currency held by a company.

Assets

Suppose a company has an asset valued in US dollars. This might be shares in a US subsidiary, or a US dollar loan it has made to another company, or a US dollar bank account. If sterling strengthens against the US dollar, each $1 unit is worth less in sterling terms, so the value of the asset – measured in sterling – declines. The company will have made a loss.

The opposite is the case if sterling weakens against the US dollar. The company will get fewer dollars for each pound, or more pounds for each dollar. So any US dollar denominated asset will be worth more in sterling terms, and the company has made a gain. A US dollar denominated liability will cost more to repay, resulting in a loss to the company.

Liabilities

If, on the other hand, the company has a US dollar liability – for example, it has borrowed in US dollars – it will cost it less in sterling terms to repay the liability. The company has made a gain. All this is summarised in the following grid:

£ movement	Foreign currency liabilities	Foreign currency assets
£ strengthens	Gain	Loss
£ weakens	Loss	Gain

Recent exchange rate mechanisms

A system of partially fixed exchange rates was introduced in Europe in 1979, in order to encourage closer economic union. This was the Exchange Rate Mechanism, or ERM. A central rate of exchange was fixed against the European Currency Unit, or ecu. The ecu was not a real currency, but was calculated from a weighted average of all currencies in the European Union.

By 1992, divergent economic performance among EU countries was putting the ERM under severe pressure. As a result, the UK and Italy left the system, while currencies remaining in the ERM were allowed to fluctuate by up to 15% either side of the central rate.

Nevertheless, progress towards closer monetary union continued to be made and at the beginning of 1999, the euro was introduced. The currencies of 12 'eurozone' countries - Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain - were tied to the euro, so that from 1 January 1999 onwards, they ceased to fluctuate against each other. From 1 January 2002, the euro became the national currency of the countries concerned.

■ FOREIGN CURRENCY AND EXCHANGE RISKS

If a business exports or imports goods or services, it will need to consider how to protect itself against fluctuations in the exchange rate. A tiny variation in the rate could cost a business thousands of pounds. How to make and receive payments in foreign currencies must be decided. This section explains how to price goods or services, how to combat the risk of exchange rate fluctuations and some of the practicalities of dealing in foreign currencies. Companies may also consider when they are carrying our significant amounts of trading in a foreign country the option of moving their business to that country to avoid the risks of fluctuating exchange rates. Amicus would seek to persuade such companies to opt for the alternative strategies set out below.

Foreign currency issues when importing or exporting
Businesses which import or export goods need to bear in mind a number of key issues when making transactions in foreign currencies.

Foreign currency transactions are sensitive to fluctuations in the exchange rate. A price agreed with a customer or supplier on one day could rise or fall if the exchange rate changes. There are steps that can be taken by companies to protect themselves against these.

If exporting, it could be best to price goods or services in the local currency of the country with which the company is trading. This depends on individual circumstances and on factors such as how it wants to present itself in that market and how competitors set their prices.

If components that are being imported are priced in a foreign currency and form part of the goods that will be sold in sterling, it must be decided how to price those goods to reflect the exchange rate. If trading with companies in the eurozone there are many practices and standards to make life easier. (See Trading in the European Union).

Identify foreign exchange risks
When a business deals in a foreign currency there is an exposure to certain risks.

It is possible that after agreeing a price for exported or imported goods the exchange rate changes before delivery, this can work both for and against a company. Some countries' currencies are more volatile than others because of their inflationary or unstable economies. This makes their exchange rates more liable to extreme movements.

Significant financial loss can be caused by fluctuations in the exchange rate. It is often safer to reduce the risk of loss by using one of the forms of hedging available through a bank.

Hedging - means insuring against the price of an item - in this case, currency - moving against you in the future. Three types of hedging are discussed in the following sections.

It is possible to trade overseas in sterling – this effectively transfers the foreign exchange risk to the business being dealt with. Whether this is an appropriate solution will depend on the product in question and the relative bargaining strength of the UK company and its trading partner.

Exchange rates can affect the competitiveness of a business even if it doesn't trade overseas. When the

currency of a country loses value against the pound, imports from that country into the UK become cheaper, so a company may have to respond to aggressive pricing from competitors who source from that country. Similarly, if a country's currency gains value against sterling, UK exports to that country become cheaper.

Forward foreign exchange contracts

One way to hedge against exchange rate movements is to arrange a forward foreign exchange contract. This is an agreement to buy or sell a specific amount of foreign currency at a certain rate, on or before a certain date.

Forward foreign exchange contracts are a secure and simple way of hedging if confident that a deal will go ahead and the currency will be required.

For example if components worth €100,000 are needed from a German supplier in 12 months' time. One euro might currently be worth 65 pence, meaning the supplies would theoretically cost £65,000. However, if the euro increases in value to 69 pence over the year, they would cost £69,000.

If the euro is expected to increase in value, a forward foreign exchange contract to buy €100,000 for £67,000 on a specified date could be organised. However, this could result in a loss of money if the euro falls in value.

This option suits businesses that:

- trade in a volatile market or to tight margins
- require large amounts of currency in relation to turnover

Advantages

- Protection against any adverse movements in the exchange rate.

- Budgets can be set knowing exactly how much the transaction costs.

Disadvantages

- The contract must proceed once arranged, regardless of whether circumstances change.
- The rate is fixed, so there would be no benefit from any favourable movement in the exchange rate.

Forward foreign exchange contracts can be arranged through major UK clearing banks and can be tailored to meet specific requirements. The cost is generally built into the exchange rate, so no other fees are payable.

Opening foreign currency accounts

An alternative way of hedging currency risk is to open a foreign currency account - a bank account operated in the UK in a chosen foreign currency.

Foreign currency accounts can be a good option for importers and exporters. They are offered by most UK clearing banks. If an account is opened in the currency in which most transactions are made, exchange rate fluctuations can be hedged against by keeping money in the account until the rate is beneficial. For example, although the UK isn't in the eurozone, a euro account can be opened here. This is useful if a lot of business is conducted with European customers, as it allows the hedging of risks for a range of EU countries at the same time.

This option suits businesses with:

- a large number of dealings in a particular currency
- a strong cashflow – i.e. unlikely to require immediate access to funds

Advantages

- Ease of access.
- Potential interest earned on deposits.

- Companies can discuss transactions in English with their own bank.
- Avoiding the cost of exchanging currency.

Disadvantages

- There will be charges for setting up and running the account.
- A loss will be faced if funds need to be converted from the foreign currency account into sterling when the pound is strong against that currency
- It may require some time for the exchange rate to become favourable - it may never do so.

Opening an account with a bank overseas

An alternative to opening a foreign currency account operated by a UK bank is to open a bank account in the country of the trading partner. This suits businesses that make or receive many (particularly small) payments in a foreign currency. The money will be held in the local currency so, as long as the funds are not needed immediately, it is possible to wait for the exchange rate to become more favourable before converting.

Advantages

- A bank in the country of the trading partner will be fully conversant with the rules and regulations regarding transactions in that country.
- Customers may prefer to deal with a bank in their own country and in their own language.

Disadvantages

- There may be communication difficulties that wouldn't be the case with a foreign currency account in the UK.
- In certain countries there are complex rules governing who is entitled to open and operate a bank account.
- Procedures to stop money laundering may mean that setting up such an account can require many stages of legal and administrative clearance.

- Overseas banks may not offer the same level of redress and protection as UK banks.

Buying currency options

Buying currency options is a more flexible form of hedging than setting up a forward foreign exchange contract - but it is more expensive.

Currency options give the right, but not the obligation, to buy a certain amount of currency at a specific exchange rate on or before a specified date. But unlike a forward foreign exchange contract, there is no obligation to buy the currency at the end of the period.

For this flexibility a premium must be paid often a minimum of £500; the exact amount will depend on the amount of currency involved and the length of the option.

This option suits businesses that:

- want to protect themselves from unfavourable rate fluctuations while retaining the flexibility to benefit from advantageous ones
- are entering into a deal which may well not go ahead

Advantages

- Protection from any adverse movements in the exchange rate.
- Benefit if the exchange rate becomes favourable.

Disadvantage

- The expense of setting the option up.

The ability to buy currency options is offered by most UK clearing banks.

Borrowing in a foreign currency

A common way of reducing currency exposure is for a company which is buying a foreign currency denominated

asset, or acquiring foreign currency investments, to borrow in the same or a related foreign currency.
For example, a company may put Canada $2 million, in the form of equity, into a Canadian subsidiary, borrowing Canada $2 million from the bank in order to do so. If the Canadian dollar weakens against sterling, the company's shares in the Canadian company will become worth less in sterling terms, but this will be offset by a corresponding exchange gain on the borrowing.

In some cases, foreign currency borrowing is used to finance the purchase of the asset or the investment - as in the above example - but a company may equally well borrow in a foreign currency to hedge an existing investment. And the borrowing does not always need to be in the same currency to provide an effective hedge. For example, a UK company may own Swiss franc denominated shares in a Swiss holding company whose principal asset is shares in a Japanese company. It might be appropriate for the company to hedge its investment by borrowing in Japanese yen instead of (or as well as) borrowing in Swiss francs.

■ TRADING IN THE EUROPEAN UNION

The countries of the European Union (EU) make up a huge market of potential customers and suppliers for business. This market can be easier to access than other overseas markets as many of the trading practices, regulations and standards apply throughout the EU. Key tasks - such as accounting for VAT on exports (sales) and imports (purchases) - have also been simplified to facilitate trade within the EU. If a company conforms with UK requirements, it will generally meet requirements throughout the EU.

This section explains the benefits of trading with other countries in the EU. It also outlines the key things companies need to consider before exporting or importing within the EU - from researching the different markets to making and accepting payments in euros.

Why trade in the European Union?

Trading with other European Union (EU) countries offers a number of key benefits to businesses in the UK. The EU's member states include some of the world's wealthiest and most productive countries. The EU is a huge market in which to sell goods and services - it also gives access to a huge source of suppliers.

At the core of the EU is the single market - the programme of freeing up the trade of goods and services and the movement of people between EU countries. The following are some of the measures which EU countries have introduced to make it easier to trade with each other:

- **Reduced bureaucracy and paperwork** – e.g. trade with the EU can be recorded on a VAT form in the same way as any sales and purchases in the UK.

- **Harmonised standards** - EU-wide technical and safety standards ensure that if UK standards are met the standards of other EU countries will also be met.

- **Movement of people** - UK citizens have the right to travel, live and work in any EU country. EU citizens can also be employed to work in the UK.

- **The euro** - has reduced the currency considerations faced by businesses trading in euros between Eurozone countries.

Other EU markets

Trading with other European Union (EU) countries may be of benefit, but particular business needs should be considered, e.g..

i) the market conditions in individual EU countries,

ii) whether particular products or services fill a niche in the market,

iii) whether those products or services would be competitive,

iv) if there are import opportunities – could materials or components of higher quality or at lower prices be found there?

Pricing products or services in euros

Of the European Union (EU) member states, 12 have the euro as their national currency:

Austria	Belgium	Finland
France	Germany	Greece
Ireland	Italy	Luxembourg
Netherlands	Portugal	Spain

If trade is carried out with the above countries - or with UK businesses which conduct a lot of their business with

these countries – it may be beneficial to companies to price their goods and services in euros.Just as sterling is the most convenient currency for most UK businesses to work with, most eurozone customers will prefer to see prices in euros.

Accept and make payments in euros

Most customers who use the euro will prefer to be able to make their purchases using the euro. Accepting payment in euros may make goods or services more attractive to a large number of potential customers across the eurozone. Importers (buyers) of goods and services from the eurozone may also need to consider making payments in euros. Depending on bargaining power it may be possible to make payment in sterling - but some vendors may be unwilling or unable to accept currencies other than the euro.

Manage euro currency risk

The main disadvantage of making and accepting euro payments is that it involves exposure to currency risks. If the exchange rate between sterling and the euro moves between the times when prices are set and when payment is made, money may be lost.

If the euro weakens after an exporting business sets its euro prices, it will still receive the agreed number of euros but these will be worth less when converted into sterling. Similarly, if the euro strengthens after an importer agrees the price in euros for a delivery of goods, the importer will need to use more sterling than expected to buy the euros needed to make the payment.

This can work the other way - gain can be made from favourable movements in the exchange rate. But exchange rate changes are unpredictable. Companies can ‘hedge’ the currency risk or counter exposure to exchange rate (see **Identify foreign exchange rate risks**)

USEFUL WEB SITES

HM revenue and customs:
http://www.hmrc.gov.uk/manuals/cfmmanual

Business link: www.businesslink.gov.uk/bdotg/action/layer

Find a local International Trade Team on the UK Trade & Investment website:
http://uktilocaloffice.thedriveris.com/

Information on past exchange rates on the Exchange Rate website:
http://www.exchangerate.com/past_rates.html?cid=238&year=&month=&last30=yes cy=239&action=Submit&cont=All

European issues website:
http://www.smallbusinesseurope.org/

European Single Market, the Department of Trade and Industry website:
http://www.dti.gov.uk/europe/asm/index.htm

A list of UK Euro Information Centres on the EU website:
http://europa.eu.int/comm/enterprise/networks/eic/eic_uk.html

Identify currency risks:
http://www.ukbusiness.hsbc.com/code/tools/site/Renderer.jhtml?cp=/public/ukbusiness/ib/en/ib_fx_ident_risk.html&bu=ukbusiness&toolName=ib&&bt=&pId=b3109380-cfd5-11d6-8b8a-080020c629df

Public procurements policies in other European countries at the OGC website:
http://www.ogc.gov.uk/embedded_object.asp?docid=1003815