EXPORT GUIDE

Foreign Exchange & Currency

Basics of Currency Exchange

Exchange rates represent the linkage between one country and its partners in the global economy. They affect the price of goods being traded, the valuation of assets, and the yield on those assets. A basic knowledge of exchange rates, currency markets, and exchange rates are essential to begin to evaluate the risks of an international sales contract.

The following pages cover the basic terms and concepts of currency exchange, as well as strategies to protect exporters against currency exchange risks.

Why Exchange Rates Are Important

When a buyer and seller are located in different countries, they rarely use the same currency in their everyday business activities. Payment is usually made in either the buyer's or the seller's currency, or in a third mutually agreed-upon currency.

One risk of foreign trade is the uncertainty of future exchange rates. The value of the currencies can change quickly, sometimes between the time a deal is concluded and when payment is received. If an exporter is not properly protected and knowledgeable, a devaluation or depreciation of one of the currencies could cause the exporter to lose money.

Spot Exchange Rates

Spot exchange rates represent the value of one currency in relation to another at a given time. The values fluctuate in response to many variables. Spot exchange rates are determined by supply and demand, which are influenced by political and monetary policy, expectation, and imports and exports.

Quick Tips on Foreign Exchange (FX) Risk Management

- The volatile nature of the FX market poses a risk of unfavorable exchange rate changes, which may cause financial losses from a sale
- The primary objective of foreign exchange risk management is to reduce the potential for currency losses
- Many foreign buyers prefer to trade in their local currency to avoid exchange rate risk
- Exchange rates are unpredictable, and attempts to profit from FX rate movements are extremely risky
- Exporters who choose to trade in foreign currencies can minimize FX exposure by using risk management techniques

Currency Demand

- Demand for foreign currency is influenced by the demand for imports or U.S. investments abroad
- The supply of foreign currency is influenced by the supply of U.S. exports and foreign investment in the United States
- If the U.S. dollar depreciates against a foreign currency in a target market, U.S. products become cheaper in the foreign market and the number of exports increases
- If the U.S. dollar appreciates compared to a currency in a foreign market, U.S. products become more expensive to purchase and exports decrease

The easiest way to avoid risks of foreign exchange rate fluctuations is to quote prices and require payments in U.S. dollars. This protects the seller from the risks of changing exchange rates and places the burden of risk on the buyer.

Mitigating Foreign Exchange Risk

Exporters may be faced with a choice of whether to conduct sales in a foreign currency or lose a sale when they operate in highly competitive markets. An exporter can use the following techniques to reduce the risks of currency losses due to foreign exchange rate fluctuations.

Non-Hedging Techniques

The simplest non-hedging technique is to price a sale in the foreign currency in exchange for receiving cash in advance. The current spot market rate determines the U.S. dollar value of the foreign proceeds. Both the exporter and importer agree to pay using today's exchange rate and settle within two business days.

A second technique is to use foreign currency receipts to pay foreign currency-quoted expenditures. An example is to use the net of a payment in Japanese Yen from a buyer to pay an agent's commissions or other outstanding bills in Japanese Yen. This option works well for companies that are consistently involved in a single foreign market, but can be difficult to utilize for exporters that do not have a steady flow of business from a single market.

Forward Hedges

A forward contract allows the exporter to sell a set amount of foreign currency at a pre-agreed exchange rate. The exporter must deliver the goods at a set date between three days and one year in the future. If all of the terms of the agreement are met, an exporter can effectively "lock in" an exchange rate payment amount with their bank by paying a fee.

An example of a forward hedge would be a U.S. exporter selling €1 million of goods to a German company on a forward rate for "60-day euro" of 0.80 euro to the dollar. 60 days after the agreement, the U.S. exporter pays their bank the €1 million they receive from their German buyer, and receive US $1.25 million, regardless of the current exchange rate.

Forward hedging reduces exchange rate risk, but requires that the U.S. exporter pay their bank at a designated date, regardless of whether their foreign buyer pays them. By hedging forward, an American exporter can protect against losses resulting from U.S. dollar depreciation between the time a contract is signed and the time payment is received. However, the company will also give up any benefits from U.S. dollar appreciation.

Forward hedges are the safest method of hedging, and are best for small exporters that have good credit. Banks often require an exporter to have collateral or a credit line equal to 25% of the contract price to cover bank risk.

Other Hedging Options

- Option hedging is a type of hedge that occurs when an exporter buys the right to purchase a foreign currency at a specific price, but is under no obligation to purchase the currency. This type of hedge is similar to buying insurance, but the up-front payment can be expensive and is non-refundable.
- Futures are similar to forward contracts, except that they are transacted by currency commodity brokers. Futures have designated call dates once each fiscal quarter. An exporter must keep a margin account with the broker, usually equal to one or two percent of a contract value. Futures are usually done for larger transactions (US $75,000 or more) and only in major currencies.
- Working capital loans are issued by an exporter's domestic banks' foreign correspondent bank. A foreign buyer pays the bank in their country in their currency and the U.S. exporter can exchange the amount in U.S. dollars whenever it becomes advantageous. This option is often not available in developing countries, and banks require that companies have sufficient collateral and good credit ratings.
- Swaps are the highest cost of all hedging methods and require extensive paperwork. In a swap, an exporter will agree to "swap" a large amount of currency at a specified date and time with a currency exchange banker. Swap agreements often include many additional contractual items to meet an exporter's needs. Because swaps are extremely complicated and often expensive, they are best used for large and complicated export transactions.

For more information on using hedging options, exporters should contact their bank. Many large banks are experienced in techniques to reduce foreign exchange risks. For help finding a bank with staff that are familiar with international trade, contact your local VEDP International Trade Manager.

Virginia Economic Development Partnership - International Trade offers a number of export-related services to Virginia businesses, including trade missions and market research by our Global Network of in-country consultants. These services are available to all Virginia exporters.

For more information, please visit our website, ExportVirginia.org.

Additional Resources

Foreign Exchange (FX) Risk Managment
Export.gov

Currency Calculator and Exchange Rate Tables
X-Rates.com

A Beginner's Guide to Hedging
Investopedia.com

Last Revised: March 2022