As the dollar depreciates, Europe beckons.

By Thomas Stapleton, People's United Bank

What a difference a year makes. In the fall of 2019, US importers and exporters were coping with a strengthening dollar and devising ways to manage the associated risks and opportunities. Today, middle market companies find themselves in the opposite position. As the dollar steadily depreciates, they face new challenges but also new opportunities as their goods become more competitively priced in foreign markets, particularly in the EU and Canada.

By early September, The WSJ Dollar Index was down around 9% since late March, and Goldman Sachs said it expects the dollar to slide 15% from its highs. Moreover, a weaker dollar may be here for the long-term, even after the pandemic's effect on the economy fades. The major reason is that the Federal Reserve has pledged to let inflation run above its previous target of 2% and not to respond to falling unemployment with rate increases. This is a recipe for a weaker dollar. For example, investors will no longer react to better U.S. economic news by bidding up the dollar in anticipation of Fed tightening. Given this dollar backdrop, middle market companies may want to rethink their exporting and importing strategies—especially now that the tariff spats between the US and the EU (its top trading partner in 2019) and Canada (its third biggest trading partner) seem to have settled down. For example, Europe has recently

Highlights

- Weakening dollar presents opportunity to rethink export/import strategies
- US exporters stand to gain overseas market share
- US importers face price increases to compensate for depreciating dollar

reduced its tariffs on US lobsters, while the US has lowered tariffs on European glassware, ceramics, lighters and lighter parts and some prepared meals that include seafood.

Exporters Gain a Competitive Edge

The good news for exporters is that a declining dollar means that their dollar-priced goods are now much more competitive in overseas markets. That makes this an ideal moment to ramp up efforts to sell into these countries and make market-share inroads. Even with the cost of transportation factored in, a 10-15% decrease in the exchange rate could create a competitive advantage.

For companies looking to facilitate new business relationships overseas, or expand existing ones, several financial tools are worth considering to expedite transactions and protect them against fraud and other losses: Letters of Credit (LOCs) and Documentary Collection. A LOC is a letter from a bank guaranteeing that a buyer's payment to a seller will be received on time and for the correct amount. In the event that the buyer is unable to make payment on the purchase, the bank covers the purchase. Due to the nature of international dealings, including factors such as distance, differing laws in each country, and difficulty in knowing each party personally, LOCs have been used for literally hundreds of years.

Documentary Collection is a trade transaction in which the exporter puts its bank in charge of collecting payment for goods supplied. The bank sends the shipping documents to the importer's bank together with payment instructions.

Documentary Collections do not provide the same level of security as LOCs. As a result, the costs are lower. But companies can purchase either LOCs or Documentary Collections for as little as a few hundred dollars.

Importers Look to Hedge Forex Risk

The circumstances created by a declining dollar create greater complications for U.S importers since they are paying for products overseas with currency that is losing value. At a certain point--and many companies have reached this point--their overseas suppliers demand price increases to compensate for the declining value of the dollar compared to their local currency. Suppliers get especially demanding for price increases if the time gap between order and payment is several months; the bigger the time gap the greater the risk that the dollar will depreciate further.

One effective strategy to avoid repricing with suppliers is for U.S. importers to buy the product in the currency of the supplier and hedge the foreign exchange (FX) risk using an FX forward product from a bank. A major caveat with this approach, however, is that Dodd-Frank rules prohibit companies with less than $10 million in assets or $1 million in net worth from engaging in derivative trading. Middle market companies that don't clear either of these bars, might try another rather simple way to hedge some FX risk: ask the exporter for a price quote in both dollars and local currency.

With both quotes in hand, the importer can choose the cheaper option on the payment date. That's a good business practice for the importer, and also for the exporter. The exporter can finely calibrate its local currency quote based on actual costs and the margins it needs to maintain. But the dual quote strategy is only appropriate for relatively short-term contracts-- 30-90 days out. The bigger the time gap between contract and payment, the less certainty the exporter has in its own local currency quotes. If possible, the companies should regularly reprice contracts to keep them within a 30-90 day time frame.

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Odds are that the weaker dollar is here to stay. With this in mind, middle market companies should take steps now to adapt and benefit from this new circumstance—especially now when the dollar is still declining and has not stabilized. The market-share inroads that companies make in the next six to 12 months could pay dividends for years to come.

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