Taking the Currency Risk out of Imports

By Thomas Stapleton, People's United Bank

No one wants to leave money on the table, but given the strength of the U.S. dollar many middle market companies that import from Europe and Canada have effectively been doing just that. Why is that? Because as the U.S. economy continues to outperform other developed markets, its currency is gaining strength. As a result, U.S. companies that price their future import contracts in U.S. dollars would sometimes be better off paying in euros or Canadian dollars.

The opportunity for savings is enormous given that the EU and Canada are the first and third biggest U.S. trading partners, respectively. U.S. goods imports from EU countries in 2018 were $487.9 billion, up 12.3% from 2017, while U.S. goods imported from Canada totaled $318.5 billion in 2018, up 6.4%, according to figures from the U.S. Trade Representative office. While trade has been increasing, the dollar's weight has been growing. From February of 2018 to November 2019, the U.S. Dollar steadily strengthened against the Euro (from 1.25 to 1.11 Euros per US$ - about 12.5%), and the Canadian Dollar (from 1.22 to 1.34 - about 10%). With some of the biggest eurozone economies struggling, and with negative interest rates on the Continent taking hold, further strengthening of the dollar seems likely.

This environment makes it

Highlights

- A strengthening U.S. dollar presents a key opportunity for savings
- Where and when a dual quote strategy can hedge currency risk
- Why shorter-term contracts work best for a dual quote strategy

generally disadvantageous to price future contracts in today's dollars—since dollars in a few months will likely be worth more. But there is an added downside to pricing contracts in dollars. U.S. importers are actually paying a fee for the privilege of overpaying in future. Here's why: when U.S. companies ask the exporter for a dollar quote, the exporter must assume foreign exchange risk (i.e., the risk that exchange rates will vary between the contract and payment dates). Aside from the usual incremental drift of exchange rates, sudden geopolitical events can also cause a spike in volatility. A geopolitical event like a vote on Brexit or a Middle East development might only move rates for a day, but if that day happens to be when a payment is due, the impact on the exchange rate could have a significant impact.

To compensate for this foreign exchange risk, the exporter will add some percentage to the price quote (usually in the low single digits). In today's currency environment, that effectively means U.S. companies are paying the exporter a fee in part to offset the strength of the U.S. dollar. To avoid this, we at People's United Bank suggest companies 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, obviously, but the exporter doesn't suffer either since the local currency quote can be very finely calibrated to the company's actual costs, which are denominated in their currency, and the margins it needs to maintain.

The dual quote strategy is particularly beneficial for middle market companies. Unlike large companies that can use various derivative strategies to alleviate forex risk, Dodd-Frank rules prohibit companies with less than $10 million in assets or $1 million in net worth from engaging in derivative trading. With fewer options to manage forex risk, the dual-quote option is a simple, straightforward way to hedge that risk.

There are limitations, however. While some companies in Canada and EU will be open to the idea, it's not a strategy that could extend to China, for example, where local companies are normally not permitted to receive local currency from offshore and will accept only US Dollars. The dual quote strategy is also 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 that 30-90 day time frame.

Given this relatively narrow time window, the dual-quote strategy is most appropriate for importers of food and other perishable items that are delivered quickly. Buyers of component materials for construction should also consider this strategy. And, given Canada's geographic proximity and relative ease of doing business thanks to the North American Free Trade Agreement (and it's replacement, the USMCA, which will hopefully be ratified soon), many importers of Canadian goods should consider this approach.

In a complex world, every so often a simple solution presents itself. We believe that asking export partners for dual quotes for short-term contracts is one such solution. There's no guarantee an exporter will agree, but it's worth asking. ■

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