112 Exchange rates

The exchange rate of a currency

An EXCHANGE RATE is the price of one currency against another. For instance, the exchange rate of the pound might be €1 = £0.58 or £1 = US$1.60. At these exchange rates, a business wanting to buy €1 million through its bank would have to pay £580,000 (€1 million x 0.58) plus a commission.

Currencies can change in value. If the exchange rate changed to € = £0.60, the business would now have to pay £600,000 (€ million x 0.60) plus commission.

- A rise in the value of the pound against other currencies means that the pound will buy more foreign currency. For example, if the value of the pound changed from £1 = €1.60 to £1 = €1.75, this would a rise in the value of the pound. Each pound is now worth €0.15 more than before. A rise in the pound is sometimes called an APPRECIATION of the currency.
- A DEPRECIATION or **fall** in the value of the pound would mean that the pound would buy less foreign currency than before. A change from £1 = $1.50 to £1 = $1.30 would be an example. The pound buys $0.20 less than before.

Sometimes, the value of a currency is said to be high. This means that it can buy more foreign currency compared to the recent historical average. For example, the recent historical average value of the pound against the euro might be £1 = €1.40. If the actual value of the pound today were £1 = €1.60, the value of the pound would be high. On the other hand, it would be low if it were well below the £1 = €1.40 level. So, for example, it would be low if the exchange rate were £1 = €1.20.

Changes in exchange rates

Exchange rates are affected by the demand for and supply of currencies. Buyers of one currency demand another currency. Sellers of one currency supply another currency.

Demand for a currency Demand for a currency like the pound, for example, comes from three main sources.

- Exports. A US business buying goods priced in pounds from a UK business would need to buy pounds to pay the invoice. The US business would be buying an export from the UK. So buyers of UK EXPORTS, goods or services sold abroad, would demand pounds.
- Capital transactions. Foreign individuals, businesses or other organisations might want to buy UK owned assets. For instance, a French company might decide to buy a UK company. It would need to buy pounds to buy out the UK company's shareholders. Or a German citizen might want to buy shares on the London stock exchange in Barclays Bank.

Question 1.

Betteny is a UK paint manufacturer. It produces paint for domestic and industrial use worldwide. The fall in the value of the pound in the early part of this year both against the US dollar and the euro was welcome news to the company. With the pound so high in the previous two years, the company had struggled along with many UK exporters to remain profitable.

The directors of the company had met to discuss their pricing strategy in the light of the fall. On the whole, they decided that they wanted to restore profit margins on export contracts by trying to maintain their prices in pounds sterling. However, the fall in the value of the pound meant that they could afford to offer slightly better prices to overseas customers if it meant that they would win a contract. In the UK market, Betteny would be better able to compete against importers which had eaten into their market share in recent years.

(a) Explain three ways in which the fall in the value of the pound this year could lead to higher profits for Betteny.

She would need to exchange euros for pounds to do this.

- Speculation. The largest source of demand for pounds on a day-to-day basis is foreign currency speculation. Dealers in foreign currency buy and sell pounds. They hope to sell at a higher price than they buy, to make a profit.

Supply of a currency The supply of a currency also comes from three main sources.

- Imports. If a UK company bought components from a United States manufacturer, it would need to buy US dollars and sell pounds to pay the invoice. So UK IMPORTS create a supply of pounds.
- Capital transactions. If UK citizens, businesses or organisations want to buy foreign assets, such as shares,

Question 2.

Rugol & Flynn's is a company which manufactures household goods. The managing director, George Rugol, is an outspoken critic of Britain's failure to join the European Monetary Union. Over the years, he has seen large fluctuations in the value of the pound against European currencies and against the US dollar. Within a matter of weeks, the pound can go up or down against key trading currencies by 5 per cent or more. This is highly disruptive to his business since his company exports mainly to Europe but also to the USA.

George Rugol is very careful to ensure that all export contracts are hedged - that is, the company buys or sells foreign currency in advance so that it knows how much it will receive in pounds on any given order. But this takes both time and money to arrange with its bankers. The company wouldn't have to do this for sales in Europe if the UK used the same currency, the euro, as its main trading partners.

Equally, the business imports raw materials. The exact price to be paid is uncertain because of day-to-day exchange rate fluctuations. Again, the company hedges all contracts but this adds to the costs of the contract.

George Rugol wants it to be as risk free to sell his products to Germany or France as it is to London or Scotland. This means that Britain must adopt the euro.

(a) Rugol and Flynn's signs a contract to export goods to France in one month's time for 50,000 euros. A week later, the value of the pound rises by 5 per cent against the euro. Explain whether the company would gain or lose out as a result?

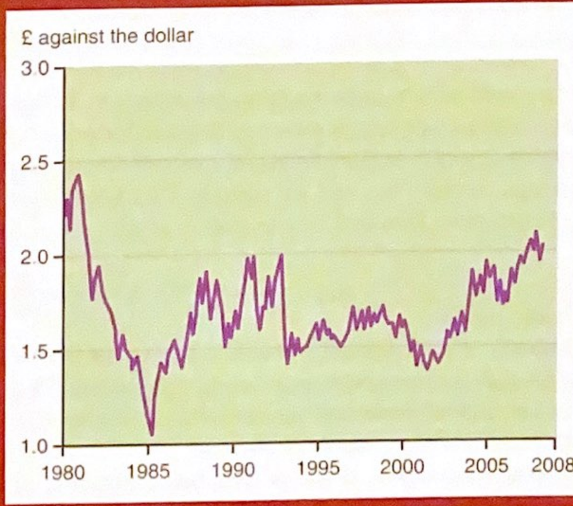
(b) Explain whether the UK joining the euro would help Rugol and Flynn's with its exports to the USA.

factories or companies, they will need to sell pounds for foreign currency.

- Speculation. Foreign currency speculators dominate day-to-day transactions. They buy and sell, hoping to make a profit.

The rate of exchange changes minute by minute depending upon how much is demanded and how much is supplied. Foreign exchange rates, therefore, tend to be volatile. Figure 1 shows how the pound has changed against the US$ since 1980.

Figure 1: The value of the pound against the dollar



Exports and exchange rate changes

Businesses can be directly or indirectly affected by changes in the exchange rate. Those most affected are likely to be EXPORTING (selling goods and services to foreign governments, businesses and individuals) or IMPORTING (buying goods and services from abroad).

Take a UK company that EXPORTS marmalade abroad. The price of a pot of marmalade is 50p. If the value of the pound is £1 = €1.60, a company abroad buying a pot of marmalade will pay €0.80 for it (1.60 x 0.50p). What if the value of the pound now appreciates (i.e. rises) to £1 = €1.80? How might the UK business react?

Keep the price in pounds the same The UK company could keep the price in pounds the same. So at 50p per pot, it would now cost the foreign company €0.90 (1.80 x 0.50p). This rise in price from €0.80 to €0.90 would affect demand (i.e. the quantity bought). It is likely that the quantity demanded would fall. The UK company would see a fall in sales abroad. By how much depends on how price sensitive was demand. If it was highly price sensitive (i.e. price elasticity of demand is high), the percentage fall in sales would be high. If demand was fairly insensitive (i.e. price elasticity of demand is low), then there would be little effect on sales.

Keep the foreign currency price the same The UK company could keep the foreign currency price the same, i.e. keep the price of the pot of marmalade at €0.80. If it did, the price it would receive in pounds would fall to around 44p (€0.80 ÷ the exchange rate = €0.80 ÷ €1.80). By adopting this pricing strategy, demand for marmalade should remain unchanged. But profits from marmalade sales would fall. It might even be the case that at 44p the business would make a loss on the sale.

So for an exporting business, a **rise** in the value of the pound is likely to result in either a fall in export sales, a fall in profits on those sales, or both. Which of these occurs depends on the pricing policy the exporting company adopts following the appreciation of the currency.

The reverse is true if the value of the pound **falls.** Exporting companies can choose to let the foreign currency prices of their goods fall. This should lead to a rise in export sales. Or they can improve their profit margins by raising the price in pounds to a level where the foreign currency price is unchanged. Or they can do a combination of the two, seeing some increase in sales and some increase in profits.

Imports and exchange rate changes

Businesses that import goods are affected by exchange rate changes too. For example, the marmalade manufacturer might import oranges from Spain. What happens if the value of the pound changes?

A rise in the value of the pound If the price of the pound goes up against the euro, it means that the company can now buy more euros for £1. So the price of imports should fall. For example, assume that it can buy 10 kilos of oranges for €1.60. At an exchange rate of £1 = €1.60, 10 kilos cost £1. But if the exchange rate of the pound now appreciates to £1 = €1.80, the cost of 10 kilos of oranges, still priced at €1.60, falls to around 89p (€1.60 ÷ €1.80).

A fall in the value of the pound The opposite occurs if the value of the pound falls. For example, the pound might depreciate from £1 = €1.60 to £1 = €1.40. Before, 10 kilos of oranges cost €1.60 or £1. After, 10 kilos of oranges still cost €1.60. But the price in pounds is around £1.14 (€1.60 ÷ €1.40). A fall in the value of the pound leads to higher import prices.

As with exports, foreign companies could adjust their own prices to compensate for the change in the exchange rate.

So, if the value of the pound **rises**, import prices in pounds will fall and foreign firms will become more competitive in the UK market. Instead of selling more exports to the UK, however, foreign firms could choose instead to raise prices in their currency. If they raised them so that the price in pounds remained the same, they wouldn't sell any more products to the UK. But they would increase their profit on each sale.

If the value of the pound **falls**, import prices in pounds will go up and foreign businesses will find it more difficult to sell into the UK market. By cutting prices in their own currency, foreign firms can bring the price in pounds back to what it was before. They, however, suffer lower profits as a result.

Direct and indirect effects of exchange rate changes on a business

Businesses can be affected directly and indirectly by changes in the exchange rate.

Directly Businesses might be affected by changes in the exchange rate directly because they sell abroad or buy imports. Many of these businesses are both exporters and importers. For them, exchange rate changes can have complicated effects.

- A UK business that buys roughly the same amount of imports as it exports can be unaffected by an exchange rate change. If the pound falls in value, the extra cost of imports can be offset by rises in the UK price of its exports.
- A UK business that has high levels of exports, but imports little, is likely to benefit from a **depreciation** of the pound. It can either allow foreign currency prices to fall and so become more competitive overseas, or it can increase its prices in pounds and so increase profit margins.
- A UK business that has high levels of exports, but imports little is likely to suffer from an **appreciation** of the pound. Either it will have to put up foreign currency prices and become less competitive or it will have to absorb the exchange rate rise by lowering its prices in pounds, resulting in lower profit margins.

Indirectly UK businesses can also suffer indirectly from exchange rate changes. This is because of the effect of a change in the value of the pound on inflation.

A **depreciation** in the value of the pound will mean that the price of imported goods and services is likely to rise. UK businesses that import these products could pass on some of the rise in price to customers, many of whom will be other businesses. So a business that doesn't import anything may still pay higher prices for supplies because of a fall in the exchange rate.

Similarly, an **appreciation** of the pound can lead to importing businesses passing on the saving made on imports to their customers in the form of lower prices.

Exchange rates and the rate of interest

Changes in interest rates can lead to changes in exchange rates. A fall in interest rates, for example, is likely to lead to a fall in the exchange rate. Lower interest rates discourage saving and investment in a country. So if UK interest rates fall, fewer pounds will be bought to invest in the UK. A rise in interest rates is likely to raise the exchange rate.

How might lower interest rates and exchange rates affect a business? Lower interest rates can **benefit** UK businesses:

- borrowing money in the UK, as they pay back less;
- selling to the UK market, because lower interest rates will encourage UK consumers to borrow and spend more;
- selling exports. They can either sell more, since prices will be cheaper to foreigners, or increase their prices and profit margins.

A fall in interest rates is likely to **harm** UK businesses because:

- inflation in the UK may increase as a result of higher import prices;
- UK businesses that import materials from abroad may be affected by a fall in the exchange rate which causes import prices to rise.

The opposite is true if interest rates rise.

Strategy and exchange rates

Many businesses find that exchange rate changes can have a major effect on their finances. They have to develop strategies to cope with exchange rate changes.

Balancing exports and imports A business could try to balance the value of exports and products that are imported. Some car manufacturers operating in the UK have adopted this strategy. If the value of the pound rises, the manufacturer lowers its export prices in pounds to leave the foreign currency price the same. But the lower revenues it earns in pounds are matched by the lower prices it has to pay for imported products. The net result is that profit is unaffected.

Similarly, if the value of the pound falls, import prices will rise for the business. But it can offset this by raising the price of its exports in pounds, which leaves the foreign currency price to its customers the same.

Becoming more competitive Changes in the value of the pound can affect two main groups of businesses. If the value of the pound rises:

- exporters will find that the foreign currency price of their goods will rise if they maintain existing prices in pounds. This will damage export sales;
- imports are likely to fall in price. This will harm sales of UK businesses that make products competing against imports.

A fall in the value of the pound will help both UK exporters and those UK businesses in competition with imports.

Both exporters and UK businesses that compete against imported products can attempt to become more COMPETITIVE. They can do this in two ways.

First, they can try to reduce their costs so they can reduce their prices to customers. If the value of the pound rises by 10 per cent, for example, UK exporters need to cut their prices in pounds by 10 per cent to maintain the same price in foreign currency. Greater price competitiveness can be achieved by more efficient methods of production. The business might be able to get better prices on the products it buys in from suppliers. The workforce may need to be reduced in numbers, with the remaining workers working more efficiently than before. In a few cases, businesses have been forced to cut the wages of workers to achieve cost savings.

Second, they can become more competitive by adding value to the products they sell. Their products might be more reliable or better designed than those available from overseas competitors. Or the UK business might promise faster delivery times.

Marketing changes One response to a rise in the value of the pound for an exporter would be to pull out of the export market. If the business judged that it simply couldn't compete at the new higher exchange rate, then it should concentrate on the domestic market. The opposite strategic response might come from a UK business which suffers competition from abroad. A rise in the value of the pound will make imports cheaper and so give foreign companies a competitive advantage. To compensate for lower UK sales, the UK business may decide that it must expand into foreign markets and so it will start to export products.

Similarly, if the value of the pound fell, this would make UK products more competitive abroad. This could be a marketing opportunity for existing exporters to expand their markets. It could also be an opportunity for a UK firm which hadn't exported before to seek out new markets abroad.

Joining the euro

At present, the UK is not part of the eurozone. Most of the rest of the European Union has had a singe currency, the euro, since 2001. What would be the implications for British businesses if Britain joined the eurozone and replaced the pound with the euro?

Over 50 per cent of all UK exports and imports go to and come from other European Union countries. Joining the euro would mean that the price of those exports and imports would be fixed for UK businesses. There would be no more appreciation or depreciation of the UK currency against other European currencies. Selling to France or Italy would be the same as selling to Northumberland, London or Northern Ireland. As a result, businesses trading with other euro countries wouldn't have to pay commission to banks to change pounds into foreign currencies. It would also remove the uncertainty caused by changing exchange rates. What will be the exchange rate when payment is made on the import or export contract?

However, UK businesses would still face these risks when selling or buying outside the eurozone. Just as the pound can fluctuate against the US dollar or the Japanese Yen, so does the euro.

KNOWLEDGE

1. What is the difference between an appreciating pound and a depreciating pound?
2. (a) An exporter charges £20 for a product sold to the USA. What would be the price in US$ if the exchange rate were (i) £1 = $1.60; (ii) £1 = $1.85; (iii) £1 = $1.35? (b) At what exchange rate would the exporter be most competitive?
3. The value of the pound changes from £1 = $1.70 to £1 = $1.40. How might a UK exporter to the USA change its prices as a result and what would be the effect on sales?
4. Why might a rise in the value of the pound force UK exporters to become more competitive?
5. How might exchange rate changes affect marketing?

KEYTERMS

Appreciation of a currency – a rise in the value of a currency.

Competitiveness – the extent to which a business or a geographical area such as a country, can compete successfully against rivals.

Depreciation of a currency – a fall in the value of a currency.

Exchange rate – the price of one currency in terms of another currency.

Exports - goods or services produced domestically and sold to foreigners.

Exporting – selling goods and services produced domestically to foreigners.

Imports – goods or services produced outside the country and purchased from foreigners.

Importing - buying goods and services produced outside a country from foreigners.

Imports - goods or services produced outside the country and purchased from foreigners.

Case Study: Hot dogs

Joseph Wolff is a major importer of hot dogs to the UK. He founded his business 20 years ago and imports mainly from Germany and Denmark. Over the years, he has had to cope with large changes in the value of the pound against both the German deutschmark, the old German currency, and the Danish krona. Today, he is no better off. The German deutschmark has been replaced by the euro. But the Danish krona still exists because Denmark, like the UK, refused to adopt the euro as its currency in 2002 when the euro was launched.

The hot dog business is fiercely competitive. When the pound depreciates in value, Wolff is unable immediately to put up prices to his UK customers. He simply has to see his profit margins reduced. On the other hand, his short-term profit margins improve when the pound appreciates in value against the euro and the krona. Over a longer period of time, he make small price adjustments, but he has to be careful not to put up his prices too much or else he would lose orders from customers.

Over the years, Wolff has tried to reduce exchange rate risks by seeing if he could buy hot dogs from UK sausage manufacturers. The quality of the UK product has been disappointing though. UK manufacturers seem to have little idea of how to make a truly great hot dog.

(a) Discuss the possible impact of changes in the value of the pound on Wolff's hot dog business. (40 marks)

(b) Consider whether Wolff would be better off setting up his own hot dog manufacturing business in the UK. (40 marks)