Opportunities Generated by Fluctuations in the Exchange Rate

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1. Origin

The risk of exchange rate sensibility may happen to any companies, including ones whose operations have nothing to do with any foreign exchange. Where is it from?

- From foreign trade: The risk is most common among companies that pay or receive currencies different from their domestic ones when they buy raw materials from foreign suppliers or receive payments from foreign buyers.

The risk of this kind is of great importance because fluctuations in foreign exchanges may affect greatly profits of companies. This risk can be quantified and companies are well aware of it.

During the 1997 Asian financial crisis when many Asian currencies fell by 80%, if American exporters for example received payments in Asian currencies, the value of their cash flow was 80% lower than the expected level. If they received payments in the dollar, they suffer no risk but Asian importers did. Wide fluctuations in exchange rates may destroy companies internationally.

- From overseas branches: If a company has a branch, or a subsidiary company, in a foreign country, it will have to face the risk to the currency of that country. The risk may materialize in transferred profit and account balances:

+ Profit transfer: Value of a constant flow of profit from the branch to the holding company will change when any fluctuation in the exchange rate takes place, which in its turn will affect the company's financial statement.

+ Account balance: Value stated in the account balance of the branch in the currency of its holding company will change according to fluctuations in the exchange rate. These fluctuations don't affect reports on business performance but they can alter important financial ratios. Similarly, the risk will become apparent when the holding company wants to sell its branch because the value of proceeds received by the holding company will change according to the exchange rate.

This kind of risk affects accounts of the holding company although the branch doesn't feel it. There may be reasonable predictions of risks of this kind.

Let's see how the Asian financial crisis affects the sensibility to exchange rate. Aggregate incomes of such companies as Black & Decker, Coca-Cola and many other American companies are very sensible to the exchange rate volatility because some one-third of their properties and sales come from overseas investments. When foreign currencies fall against the dollar, the income of holding companies also reduces accordingly. In the years 1985-88 when the dollar became weaker, American companies make huge profits because overseas incomes in foreign currencies will be higher.

During the Asian financial crisis, Asian currencies fell by 50% or more against the dollar, making the profits earned by subsidiaries companies in these countries, when converted into the dollar, were cut by half. Domino effects of the crisis were also felt by the Japanese yen, making it fall accordingly. And as a result, profits earned by American subsidiary companies operating in Japan reduced remarkably when converted into the dollar. According to the WRA, the aggregate income of companies fell by some US$20 billion in the third quarter of 1998 just because Asian currencies fell against the dollar.

- From loans in foreign exchanges: Companies can get access to loans in foreign currencies at competitive interest rates because the absolute interest rate on loans in foreign currencies is lower than the one on loans in their domestic currencies. These borrowers will face the exchange rate risk when the loans reach their maturity. Many Asian companies have suffered huge losses when they change the domestic currencies for the dollar in order to pay the interest and principal when due because the exchange rate had changed unfavorably. However, most companies can anticipate such risks and they could be quantified easily.

- From business strategies: This kind of risk is not always clear but after fluctuations in the finance market in the past decade, many companies understood that it was a bitter pill for them to swallow.

For example, a company named VDEC thinks it is free from exchange rate risk because it has no branch in foreign countries and gets no loans in foreign currencies. It uses local raw materials to make goods and sell them to local consumers. When a foreign company named, say, TNT exports the same goods to the country in which VDEC is operating, the latter will feel effects caused by devaluation of the currencies in TNT country because it makes TNT's goods much cheaper.

This kind of risk affects the corporate competitiveness and profit. After the Asian financial crisis, the exchange rates between Asian currencies experienced many sudden changes, which lead to ones in the relative competitiveness of companies.

2. What local companies can do with the exchange rate sensibility

a. Identifying fully the exchange rate risk: Local companies face permanently risks caused by the exchange rate sensibility as analyzed above. In the past, most companies failed to identify and estimate exactly possible losses caused by these risks. They could only sometimes realized effects of the risks on their payables and receivables when doing business with foreign partners but most of them thought they were immune to exchange rate volatility. After Vietnam's accession to the WTO, foreign goods and services are likely flood the domestic market when tariffs are cut as required by the WTO rules. Farm products in particular will be affected most remarkably. According to many analysts, the VND in the past few months tended to rise against other currencies because of increases in capital inflows, especially in form of financial investment. Thus, the risk of strategic sensibility is inevitable. The rise in the VND value makes local goods less competitive when the trade liberation increases, and losses for local companies may be beyond measure.

b. Measuring losses caused by exchange rate volatility: There are many methods of measuring degrees of sensibility of each risk. As for the risk from foreign trade for example, companies can identify their foreign exchange inflows and outflows, and assess overall risk degrees relating to the exchange rate sensibility in these flows. In recent years, the VaR method of measuring sensibility degrees of financial properties has been common among consultancies and proved very useful in estimating losses caused by the exchange rate risk.

As for the exchange rate sensibility of business strategies, companies had better classify cash flows according to kinds of incomes and estimate each item of income based on predicted exchange rates. By analyzing predictions of incomes in different reports on incomes based on different exchange rates, companies can assess affects of the exchange rate volatility on their income and cash flows.

c. Managing actively risks from the exchange rate sensibility: Managing the risks doesn't mean eliminating all risks that may affect the company. It only aims at adjusting the risk to the degree acceptable to the company. There are risks the company must deal with and others it could avoid by transferring them to other parties through financial derivatives. Most companies today prefer the active approach to the management of risks. With this approach, the company compensates for losses caused by changes in the exchange rate of one currency by making profit from favorable fluctuations in the exchange rate of other currencies.

Experience from the risk management carried out by foreign companies and financial institutions shows that the expenses on financial derivatives are usually very high, which makes it less persuasive in the eyes of owners of private companies and the governments as well. This means that an estimate of "the cost failure to carry out risk managing measures through financial derivatives" should be presented before introduction of a risk management plan. In addition, companies had better combine implementation of business decisions and financing programs in order to deal with fluctuations in the exchange rate with the use of financial derivatives.

As the saying goes, "fluctuations give birth to opportunities," managers with full knowledge and ability to identify possible risks to companies can make the best use of opportunities in order to avoid potential dangers and increase the value of the companies.■

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