Currency hedging

Holding back the flood

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Companies are increasingly protecting themselves against the dollar's fall

GRAVITY continues to take its toll on the dollar. This week the euro broke through $1.29, a new lifetime high. Sterling hit a 11-year high of $1.91. The strength of these currencies should be showing up in prices of European-made goods in America: dearer cars, wine and cheese. It should also help to reduce America's massive trade deficit, and perhaps even push up inflation.

But this long-overdue adjustment is happening more slowly than many expected, apparently because of two things. The first is that European firms have so far absorbed, in the form of lower profits, some of the euro's rise. This will not continue forever. But another intriguing reason was suggested by Alan Greenspan in his latest congressional testimony: firms have increasingly hedged their currency exposures. Marvellous though this may be for individual firms, such activities may be delaying the adjustment—and would mean that the dollar will fall even further than it would have done to correct America's current-account deficit.

A striking thought, but is it true? Certainly, the volume of currency derivatives (such as forwards, options and swaps) has risen sharply over the past year. According to the Bank for International Settlements, the only organisation that crunches decent if infrequent numbers, their total value rose 24% in the six months to June 2003—and the value of outstanding currency options surged by a third. But it is unclear from these statistics how much of this activity, if any, is from companies.

More than there used to be, anecdotal evidence suggests. Paul Meggyesi, an analyst at J.P. Morgan Chase in London surveyed two-dozen big European companies. Last May, they had protected about a month's worth of dollar receipts for the rest of that year. By December, they had protected more than half of the dollar revenues for this year.

The reason for their conversion to hedging is not hard to divine: adverse foreign-exchange movements can have a huge impact on profits. Last year, Volkswagen, which sells a lot of cars in America, blamed a fall in profits of more than €1 billion ($1.3 billion) on the fall in the dollar. Porsche has hedged all of its expected dollar revenues until 2007.

A blissfully easy strategy, but only with hindsight. Hedging as comprehensively as Porsche does can also be risky for any company in a market where demand is less sticky than for the iconic cars. If the dollar continues to fall, great. But if it turns around, their profits would be lower than they would have been if they had not hedged. Sometimes doing nothing is more acceptable than doing the wrong thing. Do not expect hedging to delay the adjustment too long.