APEC SME Crisis Management Center SCMC

APEC SME Economic Crisis Monitor

Publisher: Robert Sun-Quae Lai
Editor-in-Chief: Chia-Yen Yang
Published by APEC SME Crisis Management Center
Website: http://www.apecscmc.org
ISSN: 2224-8188

Email: apecscmc@tier.org.tw
Supervised by Small and Medium Enterprise Administration, Ministry of Economic Affairs, Chinese Taipei

No. 15

October 2011

Contents

Global economic risks remain high; uncertainties could last until 2012

There has been appreciable concern arising over the third quarter of 2011 for global economic risk, as the major world economies face concomitant trends towards a recession. The US Federal Reserve Chairman has publicly stated that the US economy remains subject to considerable high risks; while five major Euro debtor economies sovereign debt crisis continue to exercise the greatest effects on the Eurozone's economic climate; while the Japanese earthquake disaster has brought a tremendous economic decline and public debt problems, which have greatly enhanced Japanese economic uncertainty. As China begins monetary tightening policies designed to stave off inflationary pressures and housing prices, it may be hard to avoid some further cooling in economic growth trends.

As for economy outlook for 2011 and 2012, considering the major international economic forecasting organizations predictions for the third quarter, there indicates a clear trend towards a more conservative outlook. Although the anticipation of an imminent second global recession does not present the main voice of the market, there seems to be a developing consensus that the international economic picture will be bleaker than before expected.

Currently, global trends tend to evince a half pessimistic half optimistic status. In terms of the American economy, the US President recently announced his policies for a USD 447 billion jobs plan in his Congressional address, focusing on themes of tax reduction and expansion of public infrastructure expenditure; meanwhile the deficit plan proposed with planned measures to increase taxes on the wealthiest taxpayers, which will once again trigger debates between the Democrats and Republicans.

In addition, considering the Eurozone threats from the Greek sovereign credit crisis, currently a consensus of continuous ameliorative supports is gradually formed. From the most recent media releases, it appears that the Eurozone's senior policymakers have been aware of the necessity to establish a credible and protective firewall for stability. Along with the concern and support from the global community, there is a glimmer of hope for stabilization of the Eurozone financial system.

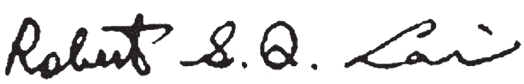
In this monitor, our critical focus will be on the discussion about the risks of another global economic recession. The crisis alert has indicated that the European and American regions will continue to remain subject to sequential uncertainties, whether political or fiscal, any of which would result in triggering the re-ignition of an economic crisis.

Meanwhile, in this monitor we have extended an invitation to experts to draw discussions about the impacts of unabated global economic imbalances on small and medium enterprises (SMEs). The global economic imbalance from sustained low economic growth and financial system instabilities will continue to exacerbate global economic liveliness, but under this circumstance SMEs will be relatively less influenced thanks to their versatility and innovation.

Also in this monitor we have discussed important aspects which SMEs need to bear in mind when facing foreign exchange rate risks through an overview by Oakbridge Limited's Principal Consultant John R. Rush explaining optimal currency risk measures among SME exporters.

In addition, we have also selected the most compelling news and provide in-depth analysis for our readers, including the latest debt crisis in the developing Eurozone that leads to declines in economic confidence indices (ECI), the US proposal with operation twist, with no positive responses from the marketplace, the hedge fund inflow resulting in massive exchange rate appreciation for the Japanese yen with Japanese official's disinterests in curbing the rising trends for the yen.

Currently the risk for another global economic recession remains considerable. Given the globalization and interconnection of world economy, it is impossible for any economy to isolate itself from impacts. This monitor will keep monitoring all the major global economic trends, helping SMEs be aware of possible risks and influences with appropriate responsive strategies.



Robert Sun-Quae Lai, Ph.D.
Executive Director
APEC SME Crisis Management Center

Beware of Purchasers who Offer Favours

John R. Rush

Background

In recent years in New Zealand (NZ), one of my banking colleagues had an SME client that was a fruit grower enjoying considerable commercial success and profitable growth in the domestic NZ market. That SME (Small and Medium Enterprise) had decided the time had come to enter into international trade and had commenced exporting its fruit to the US west coast.

The SME owners were extremely nervous about having to deal for the first time with foreign currency receivables denominated in United States dollars (USD) as they had no experience dealing in international foreign exchange markets. Moreover, there had been significant weakening in the USD at the time, which weakening was expected to persist over time.

However, the exchange rate fears of the NZ SME were alleviated when their US purchaser surprisingly suggested that they would be prepared to accept invoicing in NZ dollars (NZD) provided that they be given a discount of 3% over the invoicing period of one month as compensation for accepting the exchange rate risk in these international trade transactions. Naturally, this was good news to the NZ exporter as they were then able to completely avoid all exchange rate risk at what they regarded as a relatively small cost!

My banking colleague, being a past attendee at an Oakbridge foreign exchange workshop, sensed that the NZ exporter had adopted a financially detrimental choice and suggested that the NZ exporter invite me to write and present a customised in-house foreign exchange workshop explaining an invoicing alternative that was in their best financial interests.

Relevant Contemporary Financial Markets Data

At the time this matter was brought to my attention, respective US and NZ one month interest rates were, broadly speaking, 1.50% pa (per annum) and 5.50% pa.

Optimal Choice of Invoicing Currency for the NZ SME exporter

The use and pricing of forward foreign exchange contracts were not well understood by the NZ exporter. I explained that a forward contract was a financial markets contract undertaken with a banking counterparty whereby the bank would agree at the future forward contract settlement date to purchase (in this instance) the exporter's future USD receivable in exchange for an NZD sum **guaranteed at the time the forward contract was opened.** The implication is that the bank is offering a certain exchange rate that is good for settlement at a future time – regardless of where the spot exchange rate has moved over the forward contract period. By **invoicing in USD and then entering**

into a forward contract, the NZ exporter had thereby attained future exchange rate certainty in an uncertain world.

The NZ exporter now realised that their nervousness about incurring foreign exchange exposures as the result of invoicing in USD was misplaced. However, they then expected that this forward contract, being an instrument that insulated them from potentially volatile spot exchange rate movements, must come at a prohibitive cost.

The case study written specifically for the NZ exporter clearly demonstrated the principles by which forward foreign exchange contracts are priced. That pricing is simply a function of relative interest rates as between the two subject currencies of the forward contract. Because NZ interest rates were higher than US interest rates for the subject maturity (i.e. one month) of the forward contract, the NZ exporter would obtain a benefit of (5.50 – 1.50)% pa = 4.00% pa from the forward contract. (The guaranteed one month forward rate would be significantly better than the spot rate at the time the forward contract was instituted).

The benefit embodied in the forward contract pricing astounded the NZ exporter's directors, as they previously had an unshakable belief that taking forward cover was necessarily a costly alternative! However, the case study to which they were exposed in the workshop clearly revealed the pricing of forward contracts in such a way that the conclusion they had "discovered", while counter-intuitive, was indeed **unequivocally correct.**

Equipped with their new insights into international foreign exchange markets pricing, the directors decided at their workshop to amend their previous invoicing practice and thereafter **invoice in USD**. Remember that the NZ exporter had agreed to give their US purchaser a discount of 3% as compensation for the purchaser accepting NZD invoicing. The NZ company's directors now realised that invoicing in NZD was effectively costing them an **annualised 36%** (= 12 x 3%). They could, if they so chose, adopt an alternative method of invoicing in USD **and** completely covering their currency risk by taking a forward contract at a **certain benefit of 4.00% pa**, being a turnaround in their favour of 40 annualised percentage points.

It was now clear that the US purchaser's "favour" was extremely costly to the NZ SME exporter!

Generalised Implications of This Case Study for All SMEs

The directors of the NZ SME exporter were shown for the first time some fundamental, unchanging principles of pricing forward foreign exchange contracts. In doing so, the totally unwarranted mystique attaching to this area of financial markets practice was revealed. The NZ SME directors "discovered" that:

1. Forward contract pricing is based on **interest rate differentials;**

2. **Exporters** in a high interest rate economy will necessarily get a forward contract benefit when exporting to a low interest rate economy (and the converse is true);

3. Purchasing a forward foreign exchange contract does not **necessarily** incur a cost;

4. The widely believed notion that when a bank prices a forward contract it is somehow passing on its expectation of the future spot rate level is simply **not true**;

5. It is possible to attain **certainty** in an uncertain world of exchange rate volatility – and even get a **benefit** at the same time.

A corollary of the forward contract pricing principles illuminated in the NZ SME's workshop is that:

6. **Importers** in a low interest rate economy will necessarily get a forward contract benefit when importing from a high interest rate economy (and the converse is true). (In the NZ SME case study noted above, if the US purchaser did indeed have an NZD payable by virtue of accepting NZD invoicing and covered that payable with a forward contract, then the US purchaser would attain a **benefit** of 4.00% pa – to which would be added the invoicing benefit of 36% pa for a total benefit of 40% pa!)

Note the symmetry between the above respective principles (2) and (6). This symmetry is not an accident. It is a consequence of the well-defined, analytical means by which a forward contract is priced. This pricing is well known to banks that operate in foreign exchange markets. Those banks are generally not noted for carefully explaining forward pricing to their SME clients.

Conclusion

What became of the NZ SME?

The directors established a thriving export business to the US and always invoiced in USD and completely covered their currency risk using forward contracts. They never again rendered international invoices in their domestic currency and granted a discount to the overseas purchaser. The directors took the view that they would rather "sleep easy" than be constantly attempting to forecast future exchange rate movements. The NZ SME exporter was eventually sold for an attractive price to an international corporation. The directors retired on the sale proceeds but remain my good friends and are always happy to buy me drinks when I pass through Auckland. They continue to maintain that whatever their foreign exchange workshop cost them, it was definitely not expensive. (The author is Principal Consultant, Oakbridge Limited Financial Consulting Group, Australia) SCMC

International financial markets consultant John R. Rush (email johnrush@oakbridgelimited.com) is the Principal Consultant of Oakbridge Limited (www.oakbridgelimited.com).