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The current spot exchange rate for Korean won is \$1 = W1,200. Forecast the spot exchange rate one year from today. Explain the logic of your answer.

2. Two countries, Great Britain and the United States, produce just one good: beef. Suppose the price of beef in the United States is \$2.80 per pound and in Britain it is £3.70 per pound.
 - a. According to PPP theory, what should the dollar/pound spot exchange rate be?
 - b. Suppose the price of beef is expected to rise to \$3.10 in the United States and to £4.65 in Britain. What should the one-year forward dollar/pound exchange rate be?
 - c. Given your answers to parts a and b, and given that the current interest rate in the United States is 10 percent, what would you expect the current interest rate to be in Britain?
3. Reread the Management Focus on Volkswagen; then answer the following questions:
 - a. Why do you think management at Volkswagen decided to hedge only 30 percent of the automaker's foreign currency exposure in 2003?

What would have happened if it had hedged 70 percent of exposure?

- b. Why do you think the value of the U.S. dollar declined against that of the euro in 2003?
- c. Apart from hedging through the foreign exchange market, what else can Volkswagen do to reduce its exposure to future declines in the value of the U.S. dollar against the euro?
4. You manufacture wine goblets. In mid-June, you receive an order for 10,000 goblets from Japan. Payment of ¥400,000 is due in mid-December. You expect the yen to rise from its present rate of \$1 = ¥130 to \$1 = ¥100 by December. You can borrow yen at 6 percent a year. What should you do?
5. You are the CFO of a U.S. firm whose wholly owned subsidiary in Mexico manufactures component parts for your U.S. assembly operations. The subsidiary has been financed by bank borrowings in the United States. One of your analysts told you that the Mexican peso is expected to depreciate by 30 percent against the dollar on the foreign exchange markets over the next year. What actions, if any, should you take?

Research Task globaleedge.msu.edu

The Foreign Exchange Market

Use the globalEDGE website (globaleedge.msu.edu) to complete the following exercises:

Exercise 1

One of your company's essential suppliers is located in Japan. Your company needs to make a 1 million Japanese yen payment in six months. Considering that your company primarily operates in U.S. dollars, you are assigned the task of deciding on a strategy to minimize your transaction exposure. Identify the spot and *forward exchange rates* between the two currencies. What factors influence your decision to use each? Which one would you choose? How many dollars must you spend to acquire the amount of yen required?

Exercise 2

Sometimes, analysts use the price of specific products in different locations to compare currency valuation and purchasing power. For example, the *Big Mac Index* compares the purchasing-power parity of many countries based on the price of a Big Mac. Locate the latest edition of this index that is accessible. Identify the five countries (and their currencies) with the lowest purchasing-power parity according to this classification. Which currencies, if any, are overvalued?

CLOSING CASE

Billabong

Billabong is a quintessential Australian company. The maker of "surf wear" from wet suits and board shorts to T-shirts and watches has a powerful brand name that is recognized by surfing enthusiasts around the globe.

The company is a major exporter. Some 80 percent of its sales are generated outside of Australia through a network of 11,000 outlets in more than 100 countries. Not surprisingly, given the history of surfing, the largest

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Billabong got its start selling apparel for surfers.

foreign market for Billabong is the United States, which accounts for about 50 percent of the company's \$1.7 billion in annual sales. As a result, Billabong's fortunes are closely linked to the value of the Australian dollar against the U.S. dollar. When the Australian dollar falls against the U.S. dollar, Billabong's products become less expensive in U.S. dollars, and this can drive sales forward. Conversely, if the Australian dollar rises in value, this can raise the price of Billabong's products in terms of U.S. dollars, which affects sales negatively. Billabong's CEO has stated that every 1 cent movement in the U.S. dollar/Australian dollar exchange rate means a 0.6 percent change in profit for Billabong.

During the second half of 2008, it looked as if things were going Billabong's way. The Australian dollar fell rapidly in value against the U.S. dollar. In June 2008, one Australian dollar was worth \$0.97. By October 2008, it was worth only \$0.60. The fall in the value of the Australian dollar was in part due to a fear among currency traders that as the world slipped into a recession, caused by the 2008–2009 global financial crisis, global demand for many of the raw materials produced in Australia would decline, exports would slump, and Australia's trade balance would deteriorate. In anticipation of this, institutions sold Australian dollars, driving down their value on foreign exchange markets. For Billabong, however, this was something of a blessing. The cheaper Australian dollar would give it a pricing advantage and help to promote sales in the United States and elsewhere. Also, when sales in U.S. dollars were translated back into Australian dollars, their value increased as the Australian dollar fell. Anticipating this, in February 2009, Billabong's CEO affirmed that he expected the

company to increase its profits by as much as 10 percent in 2009, despite the weak global retail environment.

Currency markets, however, can be difficult to predict, and sharp reversals do occur. Between March and November 2009, the Australian dollar surged in value, rising all the way back to \$0.94 to one Australian dollar. The cause was twofold. First, there was a global sell-off of the American dollar as the full impact of the global financial crisis became apparent and as the scale of debt in the United States became clearer. Second, despite a recession in the United States and Europe, the emerging economies of China and India continued to grow, and this helped support demand for many of the basic commodities that Australia exports, which led to a strengthening of the Australian dollar. For Billabong, the sharp reversal was an embarrassment. The strong Australian dollar eradicated any pricing advantage Billabong might have enjoyed. Now the amount of Australian dollars that the company received for every sale made in U.S. dollars was declining. In February 2009, every \$1 earned in U.S. currency could be exchanged for \$1.66 in Australian dollars. By October 2009, every \$1 earned in U.S. currency could only be exchanged for \$1.06 in Australian dollars. In May 2009, with the Australian dollar rising rapidly, the CEO was forced to revise his previously bullish forecast for sales and earnings. Now, he said, a combination of weaker than expected demand in the United States, plus a strengthening Australian dollar, would lead to a 10 percent decline in profits for 2009. Billabong's troubles continued in 2010 as the company experienced further problems related to exchange rates.³⁴

Case Discussion Questions

1. Why does a fall in the value of the Australian dollar against the U.S. dollar benefit Billabong?
2. Could the rise in the value of the Australian dollar that occurred in 2009 have been predicted?
3. What might Billabong have done in order to better protect itself against the unanticipated rise in the value of the Australian dollar that occurred in 2009?
4. The Australian dollar continued to rise by another 20 percent against the U.S. dollar in between 2010 and 2012. How would this have affected Billabong? Is there anything that Billabong might have done to limit its long-term economic exposure to changes in the value of the currency in its largest export market?