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Authors(s)	Cotter, John; Bredin, Donal
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Managing Foreign Exchange Exposure for Irish Exports

Dr. John Cotter and Don Bredin, Michael Smurfit School of Business, UCD

All exporters need to correctly manage their foreign exchange exposure with the full support and expertise of their banks, states Dr. John Cotter.

It's scarcely surprising that, as a small open economy heavily dependent on trade, Ireland's economic statistics reflect a strong, positive relationship between our trade performance and overall economic activity. However, the slowdown in our export performance over recent years is a matter of some concern, with exports in 2003 recording a total decline of over 12% in value on the previous year, for example.

The contraction of the world economy is the oft cited explanation, while the negative effect of escalating oil prices has taken up much of the media coverage. In addition, however, the impact of foreign exchange exposure continues to create uncertainty for performance in this sector; and, to some extent, this has been overlooked.

Through the provision of currency risk management products and services, banks have a crucial role to play in helping to reduce this uncertainty. Additionally, the banking sector can further help to demystify the many myths associated with exporting and foreign exchange exposure.

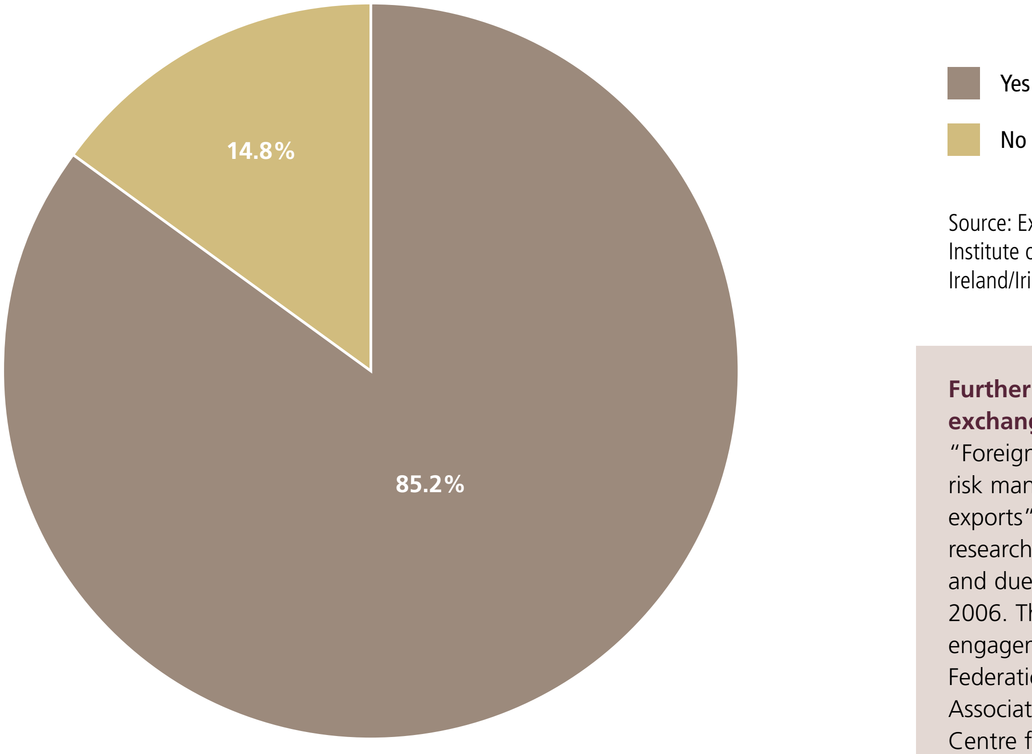
The role of the euro

It is worth noting that our membership of the euro zone has helped to mask the problems associated with foreign exchange markets. While not the main one, a key motivation for Ireland's joining the trading block of the EEC (as it was known then), followed by the European Monetary System and finally the euro zone was to expand our export trade to European markets. This has not happened to any real extent. What has happened is that the United States (US) has replaced the United Kingdom (UK) as our single largest export destination. Moreover, much of our trade with non-European economies is invoiced through sterling or US dollars and our ability to expand in these markets will be influenced by movements in these currencies.

Thus, for now and the foreseeable future, our largest export volumes will go to economies that involve foreign exchange exposure - namely, the US and the UK. Combined, they account for approximately 40% of total Irish exports.

It was a fallacy to believe that the euro would eliminate our foreign exchange exposure. Perhaps this misconception was driven by the relatively large intra-EC trade undertaken by other euro zone members. Today, perhaps it is being driven by commentators who overlook the adverse impact that foreign exchange exposure has had during the boom years. Regardless, the volatility of currency markets continues to be a key and worrying consideration for exporters as they try to ensure stability of their revenues and ultimately their profitability and competitiveness.

Does your bank meet your needs?



Source: Export Ireland Survey 2005, Institute of International Trade of Ireland/Irish Exporters Association

banks. However, the same research also shows that a significant 10% of respondents take no action to protect against currency fluctuations and thus underutilise the services available from banks.

The banking sector has a key role to play in providing support services that help underpin and grow the activities of exporters. Banks can and do provide a wealth of expertise and innovative money and currency market products to aid the performance of Irish exporters. They can also provide valuable advice and tailor-fit risk management products that are suitable to each exporter as required. And they can determine, through engaging with the exporter, the relative merits of currency risk management products, such as forward contracts, in protecting export revenues.

With the international trade environment becoming more competitive, and with changing characteristics, there is a serious challenge for our export sector to respond positively, bolstered by a strong supporting role from banks. It remains to be seen whether Irish exporters will indeed engage more and seek comprehensive support from the banking sector. Certainly closer cooperation is paramount.

There remains an imbalance between the theory of good practice in the face of foreign exchange exposure and what companies are really doing. This represents a worthwhile challenge for all concerned: exporters, the banking sector and policy makers in general, to ensure that foreign exchange exposure can be managed effectively so as to help the competitive activities of exporters and the Irish economy in general.

Dr. John Cotter is director of the Centre for Financial Markets at University College Dublin. His research and consultancy interests are in the areas of risk management and investment analysis.

Further research on foreign exchange exposure

"Foreign exchange exposure and risk management: The case of Irish exports" is the title of an important research project currently underway and due for completion in July 2006. The research arises from engagement between Irish Bankers Federation (IBF), the Irish Exporters Association and researchers at the Centre for Financial Markets, Michael Smurfit School of Business, University College Dublin.

Sponsored by a number of IBF member banks and led by Dr. John Cotter and Don Bredin, this research project is employing state of the art modelling procedures to examine foreign exchange exposure and to provide answers to relevant questions, including the following:

1. What effect does foreign exchange exposure have on the Irish export sector?
2. What effect does foreign exchange exposure have on Irish exports to the US?
3. What effect does foreign exchange exposure have on Irish exports to the UK?
4. What is the effect of foreign exchange exposure on disaggregated (industry sector) data, i.e. what is the variation (if any) of the effects of currency movements across industrial sectors?
5. How can exporters develop risk management strategies to protect them from foreign exchange exposure?