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Intereconomics

Suggested Citation: Gehrmann, Dieter; Scharrer, Hans-Eckart; Wetter, Wolfgang (1978) : Currency risk cover — an enquiry among German firms, Intereconomics, ISSN 0020-5346, Verlag Weltarchiv, Hamburg, Vol. 13, Iss. 3/4, pp. 82-87, <http://dx.doi.org/10.1007/BF02928848>

This Version is available at:

<http://hdl.handle.net/10419/139532>

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Currency Risk Cover — an Enquiry among German Firms

by Dieter Gehrman, Hans-Eckart Scharrer, Wolfgang Wetter, Hamburg *

The attitude of German exporters and importers to currency risks under a system of floating exchange rates has, for the first time, been the subject of an empirical study by the HWWA Institute. The investigation was, in the main, based on a questionnaire sent to 719 enterprises of all sizes covering all sectors of the economy. The most important findings are presented in the following article.

Foreign currency risks are not a specific feature of floating exchange rates and, thus, of the present mixed system. What marks off the risks associated with the floating regime from those inherent in the parity system is, first, that in a fixed-rate system (barring parity changes) fluctuations are kept within a certain exchange-rate band and, secondly, that when there is a risk of parities being changed, it is as a rule possible to foretell the direction, though not the time and exact measure, of a possible rate adjustment. An examination of the exchange rate movements since 1973 shows oppositely that even "basically" weak floating currencies are at risk not only in regard to the extent of possible exchange rate movements but as to their direction.

The Risks Run by Exporters

Exporters are facing risks in the following fields:

Competition and sales: The risk here is that temporarily adverse exchange ratios may render a product uncompetitive — throughout the world or in a certain region — although it would be competitive at a trend-reflecting exchange rate. This is a risk which exists irrespective of the particular currency in which the product in question is being offered.

Offer prices: If the offer price is expressed in Deutschemark, there is a risk that a price which is competitive when the offer is made will be too high by the time the customer decides on the allocation of an order because the D-Mark rate has gone up in the meantime.

Alternatively, if the offer is priced in a foreign currency, a rise of the D-Mark rate would lower the DM equivalent below the originally calculated

sum. It is in general impossible for a firm to protect itself against this risk by the usual means of compensating for exchange rate fluctuations (forward transactions, finance-hedging) because it would be left with an uncovered foreign exchange position if the order failed to materialize.

Credit and payments (if the exchange rate falls in the time between the signing of the contract and the receipt of the payment): If the goods are invoiced in D-Mark, there is a risk that the customer will request a discount, extended credit or other contract changes because the D-Mark rate has gone up and his wishes will have to be met. If they are invoiced in another currency, the exporter is exposed to an exchange risk unless he has covered himself against it.

Importers contracting in foreign currencies run no risk from exchange rate fluctuations (beyond the general risk of reduced competitiveness) before their acceptance of an offer nor are they exposed to the risk of an uncovered foreign exchange position in connection with payment delays or shortfalls when the contract has been concluded and the currency risk covered. This being the case, the commercial advantages of doing business in foreign currencies are so great that imports on a foreign-currency basis are in general to be preferred to D-Mark transactions.

The longer it takes to complete a transaction, the greater is the currency risk, for the farther ahead the completion time stretches, the more likely is the intrusion of unforeseeable exchange rate vacillations. The completion time comprises, in this sense, the whole of the period from the tendering

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FLOATING

of an offer (in the case of exports) or conclusion of a contract (for an import transaction) to the final payment.

Table 1
Average Completion Time of Export Transactions
(in % of 686 consulted exporters)

Average Time	Offer to Contract	Contract to Delivery	Delivery to Payment	Contract to Payment	Offer to Delivery
0-3 months	56.9	51.3	72.2	19.2	5.8
over 3-6 months	16.0	19.5	10.2	34.5	27.1
over 6-12 months	8.2	11.2	2.2	20.1	29.2
over 12-24 months	2.6	5.5	2.0	6.6	11.4
over 24 months	-	0.9	3.6	5.7	8.5
no information given	16.3	11.5	9.8	13.8	18.1

Completion Time Differences

The average completion time for *export* transactions, and how it is made up, is shown in Table 1. Of particular relevance to the currency risk are:

- The duration of the "offer phase" (because of the "offer risk" which can, as a rule, not be eliminated): 27 % of the consulted firms, mainly in the investment goods industry, stated that it is over three months.
- The duration of the "contract phase" (from contract conclusion to payment) for which — de-

pending on the contract currency — either the exporter or his foreign customer has to procure currency risk cover: 54 % of the consulted firms stated that the contracts were on average settled in no more than six months; forward exchange rate cover for such short terms does not normally cause any problem. Another 20 % reported contract periods of up to 12 months, and over 12 % — especially in the field of investment goods and in commerce (plant exports) — mentioned even longer contract completion times.

One of the consequences of the wide spread of contract completion times is that the exposure of different industries to the risks attending floating exchange rates varies widely.

As concerns *import* transactions, 62 % of all firms reported average contract periods of up to six months and 77 % a maximum of 12 months. Only 4 % of the firms reported contract completion times in excess of 12 months. It would thus appear that few firms are experiencing difficulties in covering the currency risks arising on the import side.

Exports Almost Entirely in D-Mark

A large proportion of the German *export* trade is actually transacted in D-Mark. In the first half of 1976 it was nearly 87 % (cf. Table 2) — slightly more than in 1972, the last year before the gen-

Table 2
Invoicing of German Export Transactions by Currencies in the First Half of 1976
(in %)

	DM	US \$	£	Sfr	Ffr	Bfr	Hfl	Lire	Others
EUROPE	85.6	2.5	1.9	0.8	3.2	1.0	1.4	1.8	1.8
EC countries	82.8	1.6	3.0	0.0	5.2	1.5	2.2	2.9	0.8
Belgium-Luxembourg	87.9	1.9	0.1	0.1	0.2	9.5	0.2	0.0	0.1
Denmark	87.3	0.8	0.1	-	0.0	0.0	0.2	-	11.6
France	81.8	1.0	0.0	0.0	17.1	0.0	0.1	0.0	0.0
Great Britain and North Ireland	74.7	3.4	21.5	0.0	0.0	0.0	0.1	0.0	0.3
Ireland, Rep.	70.0	5.2	24.7	-	0.1	-	-	-	0.0
Italy	83.1	1.3	0.3	0.0	0.0	0.0	0.0	15.3	0.0
Netherlands	84.5	1.8	0.2	0.0	0.0	0.3	13.1	0.0	0.1
Other W. Europe	89.2	2.7	0.1	2.9	0.0	0.1	0.1	0.0	4.9
State trading countries	92.2	6.5	0.2	0.3	0.1	0.1	0.2	0.0	0.4
AFRICA	96.7	2.5	0.0	0.0	0.3	0.0	0.0	-	0.5
NORTH AMERICA	79.3	19.4	0.0	0.0	0.0	0.0	0.0	0.0	1.3
USA	79.5	20.5	0.0	0.0	0.0	-	-	0.0	0.0
LATIN AMERICA	87.2	11.9	0.1	0.0	0.1	0.0	0.1	-	0.6
ASIA	93.5	4.9	0.2	0.0	0.0	0.0	0.1	0.0	1.3
Japan	81.9	5.6	0.2	0.0	-	-	-	-	12.3
AUSTRALIA, NEW ZEALAND, OCEANIA	87.9	6.7	0.2	0.0	0.0	-	-	-	5.2
Reportedly: Arab oil exporting countries	96.8	2.9	0.0	0.0	0.1	0.0	0.0	0.0	0.2
ALL COUNTRIES	86.9	4.6	1.3	0.5	2.2	0.7	1.0	1.2	1.6

Source: Deutsche Bundesbank; own calculations.

eral change to floating rates, when it was 84 %. The continuing trend towards DM invoicing was observed in business with all regions. The US dollar was the only foreign currency of major importance, and its share in the total (new) export proceeds fell in the indicated period from 6.5 to 4.6 %. Not only did the dollar lose ground in the German export trade with third countries but it did so even in exports to the USA. Other foreign currencies are playing only a limited role, and that only for exports to the countries concerned.

The large proportion of the DM transactions is mainly due to the marked preference of German exporters for contracts in D-Mark which seems well-founded in view of the risks remaining even if cover against exchange rate fluctuations is obtained, as well as for other reasons. As for the German exporters' ability to push D-Mark invoicing, the results of the enquiry do not support the hypothesis that smaller firms are in a weaker bargaining position. Among the smaller firms DM invoicing is in fact more widespread than among the big enterprises because they have an especially strong preference for D-Mark prices. While a positive view may be taken of this finding of the enquiry, it suggests that such middle-class firms may be lacking foreign-exchange know-how and flexibility in adapting themselves to market conditions abroad.

The ability to insist on DM invoicing depended essentially (whatever the size of the supplier) on the situation in the product market in question.

Accordingly, the foreign exchange situation and/or economic situation had in the view of many firms (32 and 27 % respectively) a certain influence on their ability to enforce their ideas about DM invoicing. The large proportion of DM transactions thus reflects the favourable production and/or export pattern of the German economy and the relatively strong market position which many firms are at present – still – enjoying by virtue of superior product quality (in the widest sense: including reliability of delivery).

As the proportion of trade transacted in D-Mark has increased since 1972, it might be supposed that it has become easier to present offers and invoices in D-Mark since the exchange rates were floated. The enquiry does not bear out this assumption. On the contrary: Asked whether it has "become easier or more difficult to tender or invoice in D-Mark . . . since the change to floating", 36 % answered "more difficult", 54 % noted "no change", and only 7 % found that transactions on a DM basis have become "easier". These answers may of course reflect the general experience (in a period of recession) that exporting has become more difficult.

After a sharp D-Mark rise foreign buyers are now less often than before the floating inclined to ask German suppliers to adjust their original prices. This is probably because the foreign firms are nowadays generally aware of the existence of exchange risks. If a firm fails to cover these risks, it does not normally expect the German party

Table 3
Invoicing of German Import Transactions by Currencies in the First Four Months of 1976
(in %)

	DM	US \$	£	Sfr	Ffr	Bfr	Hfl	Lire	Others
EUROPE	55.1	16.1	3.9	2.5	5.8	2.3	3.7	3.7	6.9
EC countries	53.5	15.3	5.1	0.1	7.8	3.1	5.0	5.0	5.1
Belgium-Luxembourg	66.7	7.6	0.6	0.0	0.5	20.1	0.3	0.1	4.1
Denmark	59.6	2.6	0.2	0.1	0.2	0.0	0.0	0.0	37.3
France	58.8	2.0	0.2	0.1	33.6	0.1	0.1	0.0	5.1
Great Britain and North Ireland	16.7	53.0	24.9	0.0	0.2	0.0	0.1	0.0	5.1
Ireland, Rep.	31.2	19.7	42.7	—	—	0.6	0.0	0.0	5.8
Italy	59.5	4.3	0.1	0.1	0.1	0.1	0.1	33.8	1.9
Netherlands	63.4	12.7	0.6	0.0	0.2	0.0	18.9	0.0	4.2
Other W. Europe	51.0	20.8	1.0	11.4	0.4	0.3	0.3	0.4	14.4
State trading countries	90.1	8.8	0.5	0.1	0.0	0.0	0.0	0.0	0.5
AFRICA	14.7	72.8	1.5	0.0	3.4	2.4	0.0	—	5.2
NORTH AMERICA	7.2	74.9	0.3	0.0	0.0	0.0	0.1	0.1	17.4
USA	7.0	76.1	0.2	0.0	0.0	0.0	0.1	0.0	16.6
LATIN AMERICA	13.7	83.3	2.2	0.0	0.1	—	0.0	0.0	0.7
ASIA	28.1	44.7	3.3	0.1	0.0	0.0	0.0	0.0	23.8
Japan	34.5	28.1	0.1	0.1	0.1	0.0	0.0	0.0	37.1
AUSTRALIA, NEW ZEALAND, OCEANIA	7.3	68.5	13.8	—	0.0	—	—	—	10.4
ALL COUNTRIES	43.0	31.4	3.3	1.8	4.2	1.7	2.6	2.6	9.4

Source: Deutsche Bundesbank; own calculations.

to the transaction to bear part of the currency losses.

Imports Also Largely Invoiced in D-Mark

The currency pattern of the German *import* trade is likewise marked by an unexpectedly high share of DM transactions (43%). Other countries do not transact such a high proportion of their import trade in their national currencies. The DM share actually declined compared with 1972 (50%) because the price movements in the commodity markets, and especially in the mineral oil market, led to an increase of US dollar payments. The proportion of DM transactions however still increased in the last few years as far as imports from a number of European countries are concerned.

The main reason for the high share of DM transactions is that many foreign suppliers prefer DM invoicing, as do many German firms. The interests of the two sides were often, though not always, running parallel.

The preference shown by foreign suppliers (46%) for doing business in D-Mark rather than in their own currency is surprising. They have still to shoulder risks, especially in the export trade, even if they cover themselves against foreign exchange fluctuations, and should therefore be expected to favour their own currency. The fact that the D-Mark is nevertheless often preferred suggests that many foreign suppliers have succeeded (and are still succeeding) in arranging prices, at least over the medium term, in such a way that the gains from the rising trend of the DM rate accrue (in large measure) to them.

This is not particularly surprising, for the preference of German importers for DM contracts (52%) revealed by the enquiry suggests that many of them are attaching more importance to "safety" and "convenience" than to cost advantages. If this assumption is correct, the high proportion of imports invoiced in D-Mark would not be a sign of "strength" but of insufficient flexibility in spotting and seizing market opportunities. The examination of the import pattern showed that small and medium-sized firms in particular like imports to be invoiced in D-Mark and as a result often (unknowingly) forgo a chance to buy on more favourable terms, evidently because they lack foreign-exchange know-how and an adequate perception of the price situation (as shown by comparable offers).

Internal Balancing of Currency Accounts

A firm with debit and credit accounts in foreign currencies will first of all try to balance them

against each other in order to eliminate the foreign exchange risk, for this is cheaper than covering the risk in the market. Among the 719 firms approached by questionnaire there were 219 which transacted import as well as export deals in foreign currencies, so that they were, on principle, in a position to set off foreign-currency claims against foreign-currency liabilities. The enquiry however revealed that only 13.2% of these firms engaged regularly in such offsets and 22.8% did so occasionally. The main reason for this was incompatibility of debit and credit currencies (53%) or maturities (44%).

Internal balancing of foreign-currency accounts was of the greatest importance for enterprises with a relatively large turnover (over DM 500 mn), especially those with foreign associates. They have a competitive advantage over other firms with claims and liabilities in foreign currencies.

Flexibility in Risk Covering

Firms which are unable to balance their foreign-currency debits and credits (entirely) by internal offsets must cover their outstanding currency claims and liabilities in the market if they want to avoid currency risks. Of 545 consulted exporters and importers doing business in foreign currencies no more than 17% actually covered themselves completely against such risks; 47% covered themselves partially for certain currencies, sums and maturities, and 24% refrained in principle from seeking cover for currency risks (cf. Table 4).

Table 4
Currency Risk Covering by Foreign-Currency Exporters and Importers

The currency risk is covered:	Number of firms ¹	%
Fully	93	17
Only for certain currencies	119	22
Only for a part of the sums at risk	80	15
Only for certain maturities	56	10
Not at all	128	24
No information given	96	18
Total of risk covers reported	572	
Number of foreign-currency exporters and importers	545	100

¹ Some firms reported more than one method of risk covering.

As might be expected, more firms have been seeking currency risk cover since the exchange rates were floated. This has also been the experience in other countries¹. In view of the movements of the D-Mark in the period covered by the enquiry it is not surprising to find that more firms

¹ Cf. Danmarks Nationalbank, Report and Accounts for the year 1972, p. 30, and 1974, p. 32; Sven Grassman, Currency Distribution and Forward Cover in Foreign Trade - Sweden revisited 1973, in: Journal of International Economics, Vol. 6 (1976), p. 218.

have been covering their outstanding foreign-currency claims (48 %) than foreign-currency debts (31 %).

41 % of the exporters and importers covering foreign-currency risks stated that they took up cover only when the current exchange rate appeared to them favourable; a larger percentage however (48 %) covered the currency risk immediately.

The enquiry showed that German firms are fairly flexible in adjusting to altered exchange rate conditions. Risk and cost considerations were the major factor in decisions on currency risk cover, as is shown clearly by the attitude towards cover for European compound currencies (the "snake"); fewer firms sought cover for "snake" currencies than for floating currencies because they felt that the currency risks inside the "snake" were smaller.

Forward Operations the Predominant Method

Of the methods of covering currency risks it can be said that exporters have generally a wider choice than importers (cf. Table 5). Both have access to the foreign exchange markets and can borrow, or invest in, foreign currencies. Compared with other means of covering currency risks these

Table 5
Risk Covering Techniques for Transactions in Foreign Currencies by Fields of Application and Degree of Importance

	Covering Techniques		Importance (in %)		
	Number of firms	%	small	medium	great
I. Risk covering techniques available to exporters and importers					
Forward exchange operations	262	82 ¹	32.5	28.6	38.9
Finance-hedging	102	32 ¹	42.2	35.3	22.5
II. Risk covering techniques available only to exporters					
Discounting of foreign-currency bills for crediting in DM	81	33.2 ²	40.8	33.3	25.9
Forfeiting for crediting in DM	48	19.7 ²	50.0	41.7	8.3
Factoring for crediting in DM	2	0.8 ²	100	—	—
State exchange-rate risk insurance	—	—	—	—	—
III. Risk covering techniques available only to importers					
Borrowing of foreign currencies for import purposes	4	1.7 ³	50.0	50.0	50.0

¹ Figure relates to 321 foreign-currency exporters and importers.

² Figure relates to 244 foreign-currency exporters.

³ Figure relates to 239 foreign-currency importers.

Table 6
Importance of Borrowing and Investment of Financial Resources in Foreign Currencies

Risk covering technique	Total		Importance (in %)		
	Number of firms	%	small	medium	great
Borrowing of foreign currencies (by exporters)	70	100	37.2	35.7	27.1
Investment in foreign currencies (by importers)	32	100	53.1	34.4	12.5

have the advantage of being equally available for single transactions and for debit and credit balances. The choice depends ultimately in great measure on the length of the period to be covered and the liquidity of the individual firm.

In actual fact the firms mostly resorted to the forward exchanges to cover their currency risks. Of 321 exporters and importers with business transactions in foreign currencies 262 (82 %) covered currency risks by this means while no more than 102 (32 %) ² mentioned finance-hedging as a method of which they had made use (cf. Table 5).

The outstanding importance of forward exchange operations was confirmed by the answers to the question of the relative share of the various techniques: 38.9 % of the firms stated that forward exchange operations were of great importance for them. One reason for this is no doubt the efficiency of the German market for forward exchanges of which it can be said that it is meeting the requirements well. It offers forward facilities for up to six months for all convertible currencies, as a rule without raising any problems. At a first glance this may seem to be too short a period for German exporters as investment goods account for a large part of the German export trade and longer credits are believed to be needed in this sector. Most German exports and imports, however, do in fact involve average contract periods of less than six months (cf. Table 1). Longer forward exchange deals can be arranged in foreign currencies with a relatively active market, especially in US dollars which can often be covered for two years ahead and sometimes for more than two years.

Other Instruments Less Important

Finance-hedging was of major importance only to 22.5 % of the consulted firms. To them it was much more important to borrow foreign currencies than to invest in foreign currencies (cf. Table 6). This result was, on principle, to be expected since the investment of financial resources as an offset

² The figures do not add up to a total of 321 firms (100 %) as more than one method of covering currency risks could be mentioned.

against foreign-currency liabilities presupposes adequate liquidity on the part of the investing firm. As a rule however the firms are in need of liquidity; hence foreign-currency resources are invested for very short terms only.

In addition to the two methods mentioned, discounting of foreign-currency bills, forfeiting and factoring are available to exporters who wish to cover currency risks. Of these bill discounting alone is of any great importance (cf. Table 5), primarily for big enterprises, because these bills in foreign currencies are often made out by foreign subsidiaries which are thereby released of the currency risk. A coincidental advantage of this finance instrument for the parent company is that it offers a low-cost refinancing facility. All three instruments – discounting, forfeiting, factoring – were used primarily for other motives³ than to provide cover against currency risks which however was an important side-effect.

State Insurance of Currency Risks

None of the consulted exporters availed themselves of the state insurance for currency risks. Cumbersome administrative methods, the two-year minimum period, high costs and the small number of insurable currencies were mentioned in interviews as the main reasons for the neglect of this facility. The criticism is partly based on false and incomplete information or, as regards costs, on unwarranted comparisons with foreign systems which have export subsidization as their aim rather than with the terms for alternative methods of covering currency risks.

The points of criticism mentioned are probably not solely responsible for the low interest in the state insurance scheme to date. (No more than 14 export transactions involving a total sum of DM 370 mn were insured against currency risks between the inauguration of the scheme in 1972 and the end of 1975.) Considerably more important was the fact that export transactions with contract periods of more than two years are relatively rare and that most contracts of this kind are invoiced in D-Mark, so that there is hardly any need for long-term currency risk cover.

Foreign-Currency Credits for Imports

The borrowing of foreign currencies is of some relevance to the currency risk policy also in the import trade, especially in regard to primary commodities. This emerged clearly from personal interviews with several traders with import interests. Of 239 importers approached by question-

naire however no more than 42 (17.6%) made use of foreign-currency credits, and only four of them (1.7%) said why they covered currency risks. As a rule the credits were used to finance import transactions. In a few instances they were taken up for speculative purpose.

Foreign-currency credits are a significant means of covering currency risks if a firm buys commodities for stock and the eventual sale will be based on a world market price in a foreign currency. The foreign-currency liability serves in this case as an offset for the foreign-currency asset represented by the stock item. The firm thus still bears the risk of fluctuating prices but not the additional risk from fluctuating exchange rates.

Attitudes to Floating

It was not the sole purpose of the enquiry to analyse the attitude of German exporters and importers to the invoicing of foreign trade contracts and the covering of currency risks, but it was also intended to gain an impression of their views concerning floating exchange rates. A few general questions were therefore included in the questionnaire which called for more subjective answers. It emerged from these answers that

- the majority of the consulted firms (69.6%) have not noticed any negative effects of the floating on their business activities;
- the floating probably affects smaller firms less than medium-sized and big firms;
- negative effects were most noticeable in the investment goods industry (but not in mechanical engineering or the electrotechnical industry) and in the consumer goods industry;
- a majority of the firms (52.8%), while not taking a negative view of the effect of floating rates on their business activities, would prefer a system of fixed exchange rates with occasional upward or downward adjustments;
- 22% of the firms are opposed to a return to a fixed-rate system;
- 25.2% of them have no strong views on changes in the exchange-rate system;
- 53.1% of the supporters of a fixed-rate system would rather have frequent small adjustments than occasional large exchange rate corrections, which suggests that most supporters of fixed exchange rates also regard a greater flexibility of the foreign exchange system as necessary;
- the exchange rate fluctuations have no direct bearing on the foreign investment propensities of German firms: the steady rise of the value of the D-Mark in the foreign exchange markets is of much more importance in this respect.

³ For instance: liquidity or finance motives, transfer of country risks, balance sheet improvement.