International Trade 2

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Foreword

Scoren.info

The source book you have before you belongs to the Scoren.info method. Scoren.info is the method for commercial educations at level 3 and 4. The educations are:

- Commercial employee (CM), level 3
- Contact centre employee (CCM), level 3
- Intermediary (INT), level 4
- Junior account manager (JAM), level 4
- Branch manager wholesaler (VMGH), level 4
- Assistant manager international trade (AMIH), level 4.

Qualification file

Naturally, there are requirements to the education when it comes to performing your profession. The requirements you need to meet to carry on a profession are described in a so-called qualification file.
In this qualification file, the core tasks of your future profession are described. Core tasks are the most important tasks of a profession. To master these tasks, you have to execute work processes and develop competences. Work processes are daily tasks. To properly execute these tasks, you have to develop all kinds of qualities, such as teaming up, listening, showing and taking initiative, developing your expertise and coping with stress. We call these qualities competences.
The source books and the content of the website of the Scoren.info method will guide you through this.

How does the method work?

The method consists of source books and a website. You need several source books for every education. In these source books, you find the most important theory, including a glossary with the explanation of important terms.

On the website of the method, you find tasks and extra source material. You can find the website by navigating to www.scoren.info.

Logging in to the method site

You can find the license for the method site from Scoren.info (www.scoren.info) in your book. This method site contains all sources (for example: assignments, videos and weblinks) you need.

Description of the log in process

If you want to log in to the method site for the first time, you have to activate the license first. The license can be found on one of the first pages of your book. The license is valid for 12 months, starting at the moment you activate the license.

How to activate the license

- Open your browser and navigate to www.edu-actief.nl/licentie.
- Here, you find a video about the activation of your license. Watch this video.
- Follow the steps to activate your license.
- Log in to the method site www.scoren.info with your user credentials and your password.

Chapter 1
Exchange rates

1.1 Introduction

When you do business with countries from outside the euro zone, you have to deal with foreign **currencies**. Foreign currencies have a value you have to convert into euros. In this chapter, you will read everything about exchange rates. You will learn how to list exchange rates, how to convert from and into **euros** and you will read about the agreements made in the **EU** about exchange rates.

1.2 Exchange rate: the price of foreign money

The **exchange rate** is the price of foreign money. In fact, an exchange rate is the value ratio between two currencies. How much euros do I have to pay for 1 American dollar? How much euros will I get for 26,000 Swedish krona?

Constant exchange rates € / VV

		8-2-2016	9-2-2016	10-2-2016	11-2-2016	12-2-2016
	Constant exchange rates					
1	American dollar*	1,1101	1,1236	1,1257	1,1347	1,1275
2	Japanese yen*	129,11	129,07	129,42	127,30	127,07
	Currencies in the European Union*					
4,1	Bulgarian lev	1,9558	1,9558	1,9558	1,9558	1,9558
4,2	Czech koruna	27,062	27,058	27,031	27,069	27,063
4,3	Danish krone	7,4631	7,4635	7,4638	7,4638	7,4642
4,4	Croatian krone	7,6455	7,6420	7,6350	7,6391	7,6320
4,5	Hungarian forint	310,69	311,55	311,62	311,98	310,13
4,6	Polish zloty	4,4352	4,4530	4,4289	4,4485	4,4108
4,7	Romanian leu	4,4798	4,4943	4,4830	4,4783	4,4741
4,8	Swedish krona	9,4307	9,5142	9,5162	9,5188	9,4550
4,9	British pound	0,77240	0,77945	0,77328	0,78740	0,77735

1 2 3 4

Source: website De Nederlandsche Bank.

Explanation of the numbers 1 until 4 in the table:

1. On 12-2-2016, the rate is EUR/USD 1.1275. This means that you receive USD 1.1275 for 1 euro. This way of writing is called **direct notation**: the exchange rate is written in the unit of the own currency. On 10-2-2016, 1 euro is worth 4.289 Polish zloty and 1.9558 Bulgarian lev.
2. The value of the Swedish krona is different every single day. Between 8-2 and 11-2, the value of the euro, expressed in Swedish krona's, will slightly increase. This is what we call the **appreciation** of the euro against the Swedish krona. On 12-2, the value of the euro against the Swedish krona will decrease. This is called the **depreciation** of the euro against the Swedish krona.
3. The value of the Bulgarian lev is the same all five days, even though the rates of all other currencies, expressed in euros, fluctuate each day. The value of the Bulgarian lev is connected to the introduction of the euro. Because of that, there is a **fixed exchange rate** between the euro and the Bulgarian lev. Before the introduction of the euro, the Bulgarian lev was already connected to the German mark. If there are no agreements about the value of a currency with regard to the euro, we speak of a **flexible exchange rate**.
4. Every currency has its own rate development. From 9-2 until 10-2, the value of the euro against the Hungarian forint will increase a little bit, while the value of the euro against the Polish zloty decreases at that time. As there is no fixed exchange rate between the euro and the zloty and the euro and the forint, these rates daily fluctuate because of supply and demand.

Bid price and selling rates

You buy foreign money at the bank. This applies to both cash (banknotes) and scriptural money. Buying and selling by means of cash money are transactions on your bank account. The buying rate of the bank is called the **bid price**, the opposite is called the **selling rate**.

Take a look at 'koerslijst vreemd valuta voor girale overboekingen' on www.scoren.info to see an example.

If you want to sell or buy foreign money in the form of bank notes, other rates apply. In such situations, the bank used wide margins, as the bank runs a bigger risk as opposed to transactions with scriptural money. In addition, they have to pay for the physical transport of cash money.

In the Netherlands, the official list for a great amount of currencies is set each business day at 1.30 PM. The list is based on the supply and demand on the **currency markets**. The official rate, established every business day, is called the **middle rate**. The buying rate is then based on the middle rate. This is done by deducting a percentage (a fixed margin) from the buying rate and by adding a percentage to the selling rate.

1.3 Demand for and supply of currency

If there are no agreed fixed exchange rates, there is a daily **fluctuation of the exchange rates**. The exchange rates change very single moment, as there is a continuous trade in currencies all around the world. Because of changes in the demand and supply, the exchange rates can fluctuate.

Kazakhstan tenge euro

The Kazakhstan tenge rate is strongly related to the price of oil. If the prices of oil and minerals flucturate, the rate of the Kazakhstan tenge fluctuates as well. The international monetary abbreviation for the Kazakhstan tenge is KZT.
It is easy to find the Kazakhstan tenge - euro rate.
For Kazakhstan, the value of the currency is very important, as the country strongly depends on the export. Therefore, the exchange rate of the Kazakhstan tenge is maintained by the Central Bank of Kazakhstan.

Source: www.wisselkoers.nl.

The value of the KZT strongly depends on the price of oil. If the oil price decreases, the rate of the KZT against the euro decreases as well. We have to pay more and more KZT for 1 euro. This means that the KZT depreciates against the euro.

Graphic: Exchange rate euro/KZT.

The depreciation of the KZT against the euro is a serious one. The exchange rate fluctuations of the other currencies are not as big. The following two causes of exchange rate fluctuations might not surprise you.

1. The impact of import and export.
   If there is a great demand for American products abroad, there will be a greater demand for USD. Because of this, the rate of the USD can increase against other currencies.
2. The influence of interest rate differences.
   Investors are always trying to obtain as much revenue as possible from their capital. If the interest in the United States is higher than the interest in the euro zone, investors might want to remove their capital from the euro zone to the US. Because of this, the demand of USD will increase and the rate of the USD against the euro will increase.

Sometimes, governments or central banks make an intervention to adjust rates. On 15-1-2015, the Swiss central bank put an end to the fixed connection between the Swiss Franc and the euro. The Swiss Franc became much more expensive.

Read the article and watch the video 'Zwitserse frank stukken duurder' on www.scoren.info.

1.4 Economic and Monetary Union (EMU)

In December 1991, the Maastricht Treaty was signed. This Treaty contained the agreement to start an Economic and Monetary Union (**EMU**).

An **Economic Union** means that the member countries cooperate in terms of the economy. There is free movement of goods, labour and capital. There also is a harmonisation of policies. This means that there is common understanding in economic and socio-political terms.

A **Monetary Union** means that the member countries have:
- one currency (the euro)
- one European System of Central Banks (**ESCB**) and one central bank (European Central Bank, **ECB**)
- one monetary policy regarding the interest and the limitation of inflation.

Accession to the EMU: convergence criteria
If a country wants to participate in the EMU, it has to meet four criteria: the **convergence criteria**.

The convergence criteria:
1. low inflation/price stability
   This means that the average price increase of the daily consumption cannot be too high. Annually, the inflation cannot amount more than 3%.
2. protracted low interest
   The protracted low interest (interest on long-term government bonds) can be a maximum of two percentage points above the interest of the three EU countries with the lowest inflation.
3. sound public finances
   The budget deficit has to be less than 3% of the national product, or there has to be a strong decrease and it almost has to reach the limit of 3%.
   Also, the public debt has to be lower than 60% of the national income, or the debt has to have a clear decrease towards 60%.
4. stable exchange rate
   The exchange rate has to be without **devaluation** for two years, within the standard margins of the exchange rate mechanism of EU countries (the EMS-II). A country has to be a member of the EMS-II.

Besides, a country has to adjust its central bank legislation in time. Countries wanting to be a member of the EU in the future have to meet these four convergence criteria as well.

From EMS to EMU

On 13 March 1979, the European Monetary System was founded. Countries agreed upon avoiding fluctuations of more than 2.25% of the exchange rates against a set middle rate. Some countries had a wider margin. All countries that were then members of the EU, apart from the United Kingdom, participated in this EMS.

Ten years later, in 1989, there was the approval of the Economic and Monetary Union (EMU) plan. On 1 January 1999, in the last phase, eleven countries introduced a common currency: the euro. Between 1999 and 2002, the rates of the own national currency were fixed against the euro. During that period, the euro only was a unit of account. The European Central Bank (ECB) introduced a common monetary policy. On 1 January 2002, the euro bank notes and coins were introduced in twelve countries.

Currently, the European Union consists of 28 countries, nineteen of which having the euro as their national currency. The following countries introduced the euro: Belgium, Germany, France, Ireland, Italy, Luxembourg, the Netherlands, Austria, Portugal and Spain (1999), Greece (2001), Slovenia (2007), Cyprus and Malta (2008), Slovakia (2009), Estonia (2011), Latvia (2014) and Lithuania (2015).

The euro also is a lawful currency in Monaco, San Marino, Vatican City and Andorra. In Kosovo and Montenegro, the euro is also used as a currency, but it is no legal tender there. Denmark has an **opt-out**. An exception clause states that this country does not have to introduce the euro at a later stage.

Source: Based on an article from the website of the European Commission (ec.europa.eu)

Tasks and functions of the European System of Central Banks (ESCB)

The ESCB consists of the European Central Bank (ECB) and the national central banks from all member states of the European Union (EU).

The tasks the ESCB has to execute are:

- setting and executing the EU monetary policy
  This means that it has to make sure that the total mount of money does not become too much, to limit the inflation. Also, the interest has to be maintained and the value of the euro against other currencies has to be stabilised.
- holding back and managing official reserves of member states
  Approximately fifteen per cent of these monetary reserves consist of gold. The rest of it are currencies, such as the Japanese yen and the American dollar.
- encouraging smooth operation of the payment systems
- the issue of bank notes
  The ECB has the exclusive right of issuing bank notes within the euro zone. The bank notes issued by the ECB and the national central banks are the only bank notes being legal tender within the euro area.

1.5 EMS-II

A few member states of the European Union (still) haven't introduced the euro. The value of the currencies of these countries fluctuates against the euro. The European Monetary System II (**EMS-II**) is a set of agreements made to stabilise the exchange rates between the euro zone and the other member states of the EU. Big fluctuations in exchange rates upset the financial markets and obstruct the free trade. Stable exchange rates contribute to stable trade flows.

The agreements for the EMS-II are made between the ECB and the central banks of all member states from outside the euro zone. Participating in the EMS-II is voluntary.

The Danish crown (DKK) is a part of the EMS-II. The agreed central rate EUR/DKK amounts 7.46038, with an allowed fluctuation of at most 2.25% upwards or downwards. In the ECB overview from 2016, the countries outside the euro zone are mentioned as well. Lithuania entered into the euro zone on 1-1-2016 and has left the EMS-II. EMS-II is sometimes called the Exchange Rate Mechanism II (ERM-II).

Overview table of economic indicators of convergence

		Price Stability	Government budgetary developments and projections			Exchange rate		
		HICP inflation 1)	Country in excessive deficit 2) 3)	General government surplus (+) / deficit (-) 4)	General government debt 4)	Currency participating in ERM II 3)	Exchange rate vis-a-vis euro 3) 5)	Long-term interest rate 6)
Bulgaria	**2014**	**-1.6**	**No**	**-5.4**	**27.0**	**No**	**0.0**	**3.3**
	2015	**-1.1**	**No**	**-2.1**	**26.7**	**No**	**0.0**	**2.5**
	2016	**-1.0**	**No**	**-2.0**	**28.1**	**No**	**0.0**	**2.5**
Czech Republic	**2014**	**0.4**	**No**	**-1.9**	**42.7**	**No**	**-6.0**	**1.6**
	2015	**0.3**	**No**	**-0.4**	**41.1**	**No**	**0.9**	**0.6**
	2016	**0.4**	**No**	**-0.7**	**41.3**	**No**	**0.9**	**0.6**
Croatia	**2014**	**0.2**	**Yes**	**-5.5**	**86.5**	**No**	**-0.7**	**4.1**
	2015	**-0.3**	**Yes**	**-3.2**	**86.7**	**No**	**0.3**	**3.6**
	2016	**-0.4**	**Yes**	**-2.7**	**87.6**	**No**	**0.5**	**3.7**
Hungary	**2014**	**0.0**	**No**	**-2.3**	**76.2**	**No**	**-4.0**	**4.8**
	2015	**0.1**	**No**	**-2.0**	**75.3**	**No**	**-0.4**	**3.4**
	2016	**0.4**	**No**	**-2.0**	**74.3**	**No**	**-0.7**	**3.4**
Poland	**2014**	**0.1**	**Yes**	**-3.3**	**50.5**	**No**	**0.3**	**3.5**
	2015	**-0.7**	**No**	**-2.6**	**51.3**	**No**	**0.0**	**2.7**
	2016	**-0.5**	**No**	**-2.6**	**52.0**	**No**	**-4.2**	**2.9**
Romania	**2014**	**1.4**	**No**	**-0.9**	**38.8**	**No**	**-0.6**	**4.5**
	2015	**-0.4**	**No**	**-0.7**	**38.4**	**No**	**0.0**	**3.5**
	2016	**-1.3**	**No**	**-2.8**	**38.7**	**No**	**-1.0**	**3.6**
Sweden	**2014**	**0.2**	**No**	**-1.6**	**44.8**	**No**	**-5.2**	**1.7**
	2015	**0.7**	**No**	**0.0**	**43.4**	**No**	**-2.8**	**0.7**
	2016	**0.9**	**No**	**-0.4**	**41.3**	**No**	**0.6**	**0.8**
Reference alue 7)		**0.7**		**-3.0**	**60.0**			**4.0**

Overview of convergence criteria and participation in the ERM-II.
Source: ECB, Convergence report, June 2016.

1.6 Glossary

Appreciation
Price appreciation of a currency resulting from supply and demand.

Bid price
The price the bank pays for foreign money. The buying rate for the bank.

Convergence criteria
Requirements a country has to meet in order to participate in the EMU.

Currency market
The total amount of supply and demand of currency types.

Depreciation
Currency decline of a currency resulting from supply and demand.

Devaluation
An official decrease of the rate of a currency by monetary authorities.

Direct notation
Exchange rate indicating the value of the own currency in another currency (for example: 1 EUR is USD 1.22).

ECB
European Central Bank.

Economic Union
An economic cooperation where there is free movement of goods, services, labour and capital, as well as equal external tariffs and harmonisation of the economic policy.

EMS-II
European Monetary System II. Agreements about the stabilisation of currency exchange rates of countries wanting to access the euro zone (EMU) against the euro.

EMU
Economic and Monetary Union.

ESCB
European System of Central Banks.

EU
European Union. A economic and political cooperation between European countries.

Euro
EU currency.

Exchange currency
The price of a foreign currency.

Fixed exchange rate
Exchange rate based on agreements made on the value of a currency against the euro.

Flexible exchange rate
Exchange rate where the price formation completely depends on the supply and demand.

Fluctuations
Rate (= value) fluctuations of the currency.

Middle rate
The official list of currencies, based on supply and demand in the currency market, established every business day.

Monetary union
A cooperation with one central bank which has the authority to set the exchange rate policy for the common currency.

Opt-out
Exception clause in European Treaties to eventually introduce the euro.

Selling rate
The price a bank asks for foreign money. The selling rate for the bank.

Chapter 2
Exchange rate risks

2.1 Introduction

You are the assistant manager international trade and you are selling goods to a Swedish buyer. The buyer has to pay you SEK 386,000,-. The EUR/SEK rate is 9.3525. This means that the counter value of the contract is € 41,272,-. However, you agreed with the Swedish customer that he pays after two months. You run a **currency risk** or an (exchange) **rate risk**.

Two months from now, the SEK rate can be different than today's rate. If the SEK value two months from now is lower than today's SEK value, you will receive less euros than you thought. On the other hand, if the SEK rate is higher two months from now than it is today, you might be surprised and receive more money.

You are the manager, no speculator. Therefore, you try to avoid rate risks within reasonable limits. In this chapter, you read more about the possibilities to avoid these risks.

What is the exchange rate?

2.2 Internal hedging techniques

There are different ways to limit the exchange rate risks or even completely hedge these risks. You can choose between internal and external hedging techniques. You apply an **internal hedging technique** within your company, or you agree upon the technique with your customer.

There are three internal hedging techniques:
1. choice of invoicing currency
2. matching
3. including exchange rate clauses.

Choice of invoicing currency
Are you an exporter and do you want to exclude currency risks? Have your customer pay in euros (even outside the euro zone). This way, your customer is the only one running the risk of exchange rate fluctuations. He has to buy euros to pay your invoice. The question is whether or not the customer agrees upon that.

If both the seller and the buyer do not accept each other's currency, they can choose to work with another foreign currency. If they choose a currency with a stable exchange rate, the currency risk is limited for both parties.

Matching
Another hedging technique is **matching**. This means that you try to align incoming foreign currencies and outgoing foreign currencies. In practice, you maintain a bank account for foreign currencies. You call this bank account a foreign currency bank account. This is handy if you have both payments and revenues in foreign currencies.

An advantage of matching is that you avoid exchange costs. If you have a USD account and you receive a payment on that account, you can use the received USD to make a payment in USD. You do not have to exchange the money to another currency, for instance the euro.

Rabobank

A foreign currency bank account is a bank account you can use for 32 different currencies. The foreign currency bank account allows you to receive currencies without having to convert them in euros. You maintain a foreign currency bank account for every foreign currency you use. It has the same bank account number as your regular business account, but it has a different currency code. Incoming amounts in a foreign currency are recorded on the applicable account.

Source: www.rabobank.nl.

Including exchange rate clauses
You can include clauses (agreements) in your sales contract. In case of exchange rate clauses, the seller and the buyer agree upon the way they are going to match the exchange rates. By including an exchange rate clause, you spread out the consequences of exchange rates over the seller and the buyer. You can also agree that the clause only takes effect is the rate fluctuation exceeds a specific margin. The exchange rate clause therefore also has to include the distribution key (for example 50%-50% or 30%-70%).

Example Pensi General Conditions

13. Adjustment of the purchase price.
The Seller reserves all rights to adjust the purchase price should foreign exchange rates, import levies or other charges independent of the supplier, taxes or other fees under public law change before the Buyer makes payment. In the event of foreign exchange rates affecting the purchase price, the Seller is entitled to adjust the euro-denominated price on a pro rata basis to the change in exchange rates in respect of that part of the price that the Seller has not received by at least one business day prior to the date at which the change occurred. In this context, business day means a day on which Finnish banks sell foreign currency.

In the event of a change in the foreign exchange rate, the exchange rate of the date of payment is to be compared with that of the date of offer. If the parties have agreed to apply a different exchange rate after the date of offer, this is to be used instead of the rate on the date of offer. If the foreign exchange rate changes after the maturity date of the invoice and the purchase price has not been paid in full, the minimum price in euros is determined according to the exchange rate at the maturity date.

Source: www.pensi.fi.

The example of the Finnish company Pensi shows the following:
- Pensi is allowed to change the selling price when the exchange rate changes.
- Pensi moves the rate risk towards the buyer.

2.3 External hedging techniques

There are different approaches to limit or hedge exchange rate risks. You can choose for internal or external hedging techniques. You need service providers for an **external hedging technique**, such as a bank or an insurance company.

There are three external hedging techniques:
- using the forward rate via a foreign exchange contract
- currency options
- exchange rate insurance.

Forward rate

The **forward rate** is an exchange rate you agree upon with the bank today, for a delivery/purchase in a foreign currency in the future. In case of shorter periods, the forward rate depends on differences in interest rate. If you make calculations with forward rates, you have to know certain professional terms. Two common professional terms are ‘premium’ and ‘discount points’.

Premium means that the forward rate is higher than the current rate, the **constant rate**. The opposite of premium is **discount**: the forward rate is lower than the constant rate.