Long Live ROC and ROE!

By Lothar Katz

These days, a lot of people worry about where ROEs may be taking us. I'm not referring to Returns On Equity here, though those might raise concerns as well; I'm talking about *Rates Of Exchange*.

Long-term variances in exchange rates tend to resemble roller coaster rides. You'll find lots of ups and downs, some of them pretty steep ones. Take the U.S. Dollar versus the Euro, for instance: their ROE started out at 1.11 with the introduction of the Euro in 2002, thereafter dropping considerably, going up again, and repeating similar cycles several times since. Over the past ten months alone, it dropped more than 17%, from 0.81 to 0.67, apparently propelled by concerns over U.S. debt rates that outweighed those over the economic troubles of EU members such as Greece or Portugal. Similarly, the Indian Rupee saw considerable ROE swings against both other currencies during the past decade; the Chinese Yuan, though artificially pegged to the Dollar, experienced at least a bit of a roller coaster ride versus the Euro.

Financial changes of such magnitude represent considerable risks for individuals, companies, and countries. That's bad, right?

Well, not necessarily. Risk is not –as people frequently but falsely assume– the probability and impact of *SOMETHING BAD* that might be happening. Rather, it is defined as the probability and impact of *SOMETHING*. In other words, ROE risk represents as much of an opportunity as it is a threat. A weakening currency, for example, is a great thing if you're exporting products or services. It means that you're getting more money once you converted the foreign proceeds back to your home currency. The opposite is true for importers, who benefit whenever their own currency appreciates. If desired, both of them can leverage financial instruments, such as currency hedging, in order to mitigate the potentially bad effects of ROE risk.

How ROE Impacts ROC

Let's look at a bigger impact of exchange rates: their effect on overall economic *Rates of Change*. A little known fact is that the United States, the world's leading export nation between 1948 and 1985, was thereafter repeatedly surpassed, in export Dollars, by comparatively puny Germany. This was propelled by the attractiveness of the latter's automotive and industrial products, as well as the corresponding appreciation of its currency. In fact, Germany proudly held the title of 'World Export Champion' from 1986-88, in 1990, and again from 2003-2008. Many Germans, and quite a few economists, believe that these successes have strongly contributed to the overall strength of the Euro.

Over the past three years, the ranking saw considerable changes, though. In 2009, China surpassed Germany for the first time to become the world's leading export nation, relegating the U.S. to third place. Germany and the States swapped positions in 2010, which had a lot to do with –you guessed it– ROE trends. We're likely to see these two trading places again, for similar reasons, in 2011, although Germany may not be able to reclaim the top spot. China, which only last year underlined its intentions to make the Yuan fully convertible, will eventually see its export strength affected by ROE changes to a larger degree, too. What all of them experience over time are the stabilizing forces of ROE: countries with strong currencies tend to export less and import more, both of which erodes at least some of their global competitiveness in the long haul.

So What?

So what does all this mean for *you*? If you're looking at this from a U.S. perspective, realize that the strong Euro represents an outstanding opportunity to grow your exports, especially into all EU markets. If you're in export-oriented Germany, well, you might want to stop worrying about the Euro not being strong enough and start worrying about it being *too* strong unless your business is all about importing. In any case and no matter where you are and which markets you serve: it pays to discover the opportunities that lie in those ever-changing ROEs, not just the threats!

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