Is it Time to Prioritize Currency Hedging?

As central banks diverge on interest rates, businesses are faced with an increasingly complex financial landscape where the ability to predict currency movements becomes even more challenging.

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In today's global economy, businesses face an increasingly complex financial landscape. With the world's dominant central banks diverging on interest rates and significant political changes on the horizon, coupled with ongoing conflicts affecting supplying chains, the ability to predict currency movements has become more challenging than ever.

These fluctuations go beyond just the UK. Over 2 billion of the world's population are set to be voting this year, including leadership elections in the US and EU. Around the world, new economic policies are being introduced, meaning businesses must find ways to ensure greater stability for international payments. What's more, conflict is having a significant impact on global supply chains and inflation, creating heightened market volatility that has a knock-on effect on currencies.

Amid this economic instability, currency hedging can provide a vital strategy to mitigate risks associated with currency fluctuations.

What is currency hedging, and why is it needed?

Currency hedging is used to reduce the risks associated with fluctuations in exchange rates. When dealing with multiple currencies, businesses are exposed to the danger of exchange rates shifting out of favour. Not only does this cause unpredictability, but it also impacts the overall value of international transactions. Currency hedging can be seen as a shield that protects, stabilizes and removes uncertainty when dealing with multiple currencies.

There is a misconception that currency hedging involves a degree of gambling on the market. However, this is the opposite of what currency hedging entails. Without hedging, businesses are left exposed to market movements.

With hedging, you remove the risk of market ups and downturns by choosing a set currency exchange rate and locking this in for future payments. This can help to protect profit margins and enhance financial predictability.

When should businesses use currency hedging?

Businesses should consider currency hedging when engaging in any international transactions, such as purchasing goods, paying suppliers, or repatriating profits.

Hedging can be particularly valuable during periods of significant political or economic uncertainty, such as election periods, which often leads to volatile currency markets. For example, take the 2010 election which saw David Cameron's Conservatives enter a coalition with the Lib Dems. Following this outcome, the pound stumbled, losing almost two cents to both the euro and the US dollar[1] overnight. The 2016 Brexit vote was another harsh blow, dropping sterling down 11%[2] to a 31-year low, from \$1.50 to \$1.33.

Whilst the pound did eventually stabilize after each instance, it is volatility such as this that can have a huge impact on businesses that have failed to use currency hedging for future payments.

Making currency hedging accessible to SMEs

Traditionally, currency hedging has been associated with large multinational corporations. However, advancements in financial services have made these strategies more accessible to small and medium-sized enterprises (SMEs).

Online platforms and fintech companies now offer hedging solutions tailored to the needs of smaller businesses, enabling them to protect their operations from currency risks without needing extensive financial expertise.

The benefits and risks of currency hedging

There are a number of benefits in using currency hedging including:

- **Stability:** Hedging provides businesses with a stable exchange rate, making it easier to predict costs and revenues.
- **Risk mitigation:** By locking in rates, businesses can protect themselves from adverse currency movements.
- **Financial planning:** Hedging enables more accurate financial forecasting and budgeting.

However, it is important to watch out for the risks. These include:

- **Commitment to fixed rates:** Hedging involves committing to a specific exchange rate, which could lead to opportunity costs if the market moves favourably.
- **Complexity:** Understanding and implementing hedging strategies can be complex, requiring expertise or consultation.
- **Cost:** There are costs associated with hedging instruments, which businesses must consider in their financial planning.

Gaining stability amid uncertainty

Financial strategies and currency hedging are important when safeguarding a business against the unexpected. Working with financial advisors to gain a greater understanding of hedging can be a crucial way for business leaders to manage their risks more effectively.

Reference

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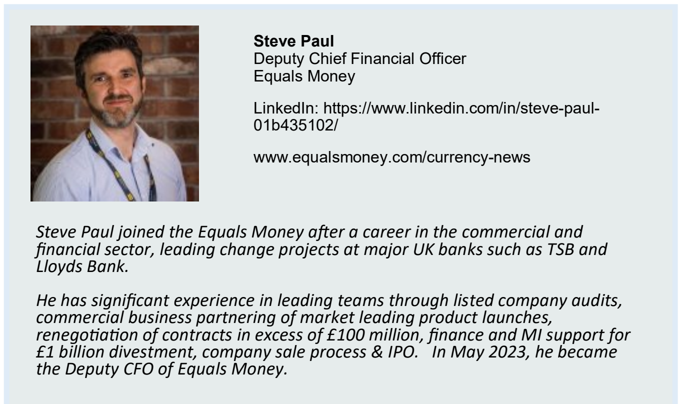
[2] Guy, A. (12 October 2022) ‘The 100-year decline of the British pound from five to one dollar’, Interactive Investor. Available at: https://www.ii.co.uk/analysis-commentary/100-year-decline-british-pound-five-one-dollar-ii525603



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Steve Paul joined the Equals Money after a career in the commercial and financial sector, leading change projects at major UK banks such as TSB and Lloyds Bank.

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