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Economic Environment

Exchange Rates & the Component Manufacturer: What Do They Mean? by Al Schuler

Do you know how fluctuating currency exchange rates can affect your business?

The exchange rate is the "price" at which one currency can be converted into another. That "price" fluctuates daily, creating both winners and losers. For example, the value of the dollar can be both good and bad for Americans at the same time. The most important exchange rate for American component manufacturers is the one between Canada and the U.S. due to the enormous volume of trade between the two countries. In this introductory[1] article, we will discuss:

- How exchange rates are determined.
- Factors contributing to a strong currency and who wins and loses as the dollar strengthens.
- Factors contributing to a weak currency and who wins and loses when the dollar weakens.
- Where the exchange rate is currently and where it is headed.

CLICK ON IMAGE FOR LARGER VIEW

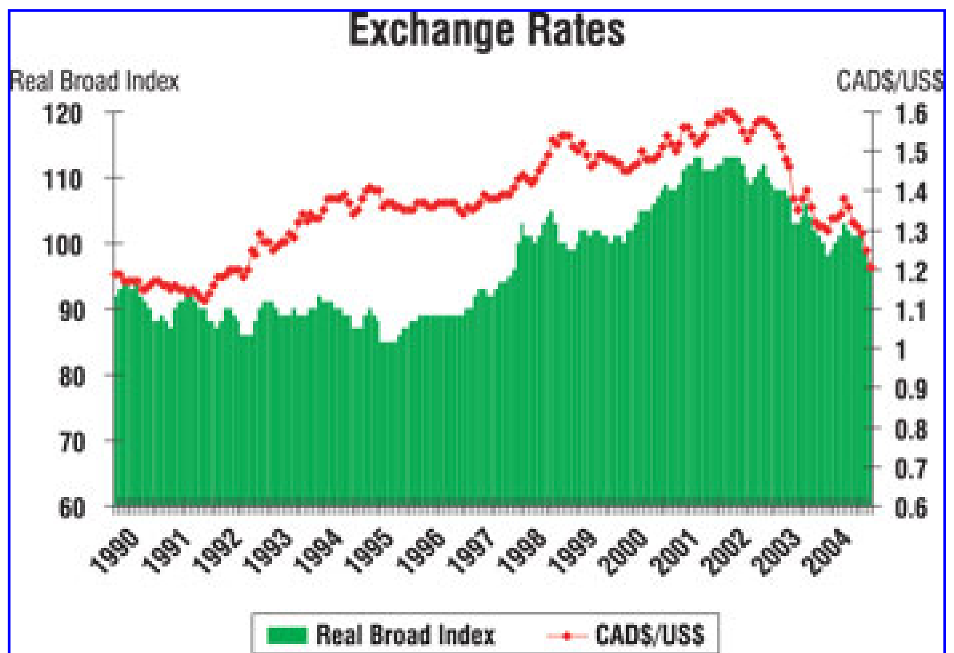

FIGURE 1. THE U.S. DOLLAR WEAKENS 14 PERCENT IN REAL TERMS AGAINST OUR MAJOR TRADING PARTNERS AND 24 PERCENT AGAINST THE CAD

(Please note that the following abbreviations will be used throughout this article: USD = United States dollar and CAD = Canadian dollar.)

Exchange rates can have major impacts on the economy, interest rates and inflation. A chronically weak dollar can be inflationary, driving up interest rates and putting a damper on the housing market and consumer spending in general. For Canadian lumber manufacturers, a strong CAD (weak USD) reduces margins for Canadian mills (their costs are in CAD, yet revenue is in USD when selling to the U.S. market so a strong CAD effectively reduces their revenues), and this can affect lumber shipments to the U.S. A basic knowledge of exchange rates can be useful to U.S. component manufacturers (CMs) by enhancing their understanding of trade flows and providing information to tailor their business plans to take advantage of fluctuating exchange rates.

FIGURE 2. LUMBER IMPORTS

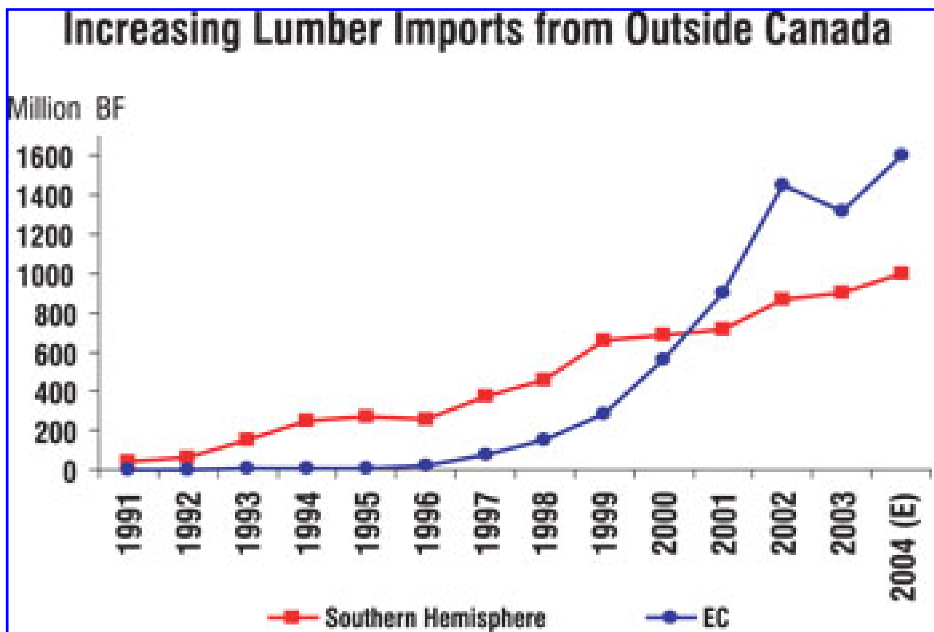

FIGURE 3. U.S. IMPORTS FROM NON-CANADIAN SOURCES

FACTORS THAT DETERMINE EXCHANGE RATES & THE WINNERS & LOSERS WHEN RATES SHIFT

The price of a currency is determined by supply and demand, much the same as the price of lumber (note that foreign exchange markets are not purely competitive: see the footnote below). If demand for U.S. dollars is greater than supply (determined by the Fed and the U.S. Treasury), the "price" or exchange rate strengthens. Conversely, if demand is less than supply, the exchange rate will weaken. Some factors contributing to a strong currency (by increasing demand for dollars) include: higher interest rates in U.S. than abroad, lower inflation, a strong U. S. economy relative to the rest of the world, more stable political environment in the U.S. versus other countries and having strong domestic financial markets. Factors contributing to a weak currency are opposite of the above: lower interest rates in the U.S. versus other countries

and higher rates of inflation in the U.S. A strong U.S. currency produces winners and losers. U.S. consumers win due to lower prices on foreign goods, while U.S. firms lose because they find it harder to compete in foreign markets. Conversely, weak currency winners are U.S. exporting firms and U.S. capital markets, while losers include U.S. consumers and U.S. investors expanding into foreign markets.

CURRENT SITUATION

Throughout the 1990s and through the spring of 2002, the USD strengthened in large part because the U.S. economy was performing much better than Europe and Japan (see Figure 1). In fact, the dollar actually became overvalued by as much as 25 percent by some estimates (see footnote). By mid-2003, the negative balance of trade (current account deficit) was getting quite large (trade deficit exceeded five percent of GDP in 2004), and the dollar weakened as falling foreign direct investment in the U.S. reduced demand for U.S. dollars. The real Broad index is a weighted average of the currencies of our major trading partners, inflation adjusted. As seen in Figure 1, since spring of 2002, the U.S. dollar has fallen 14 percent against our major trading partners in inflation adjusted terms while falling 24 percent against the CAD. The CAD is tied closely to commodity prices, and with the strong world economy, commodity prices are at very high levels. In addition, Canadian interest rates are higher than here in the U.S., and their balance of trade is positive, both supporting a strong CAD.

EXCHANGE RATES & WOOD PRODUCTS

International trade is very important to our wood products industry. Almost 40 percent of our softwood lumber is imported, most of it from Canada, but we are seeing increasing volumes of framing lumber from Europe and industrial lumber from the southern hemisphere (see Figures 2 and 3). Normally, as the U.S. dollar weakens, as it has for the past 30 months (Figure 1), we would expect this to favor exports from the U.S. (they become cheaper to foreigners) and discourage imports into the U.S. (they become more expensive to American importers). But it isn't that simple. Let's analyze lumber markets and try to determine whether the weak U.S. dollar can impact lumber prices here in the U.S. Let's look at import flows from Canada, the source of most of our lumber imports. A Canadian producer will continue to ship to the U.S. market as long as his margins are acceptable. But those margins are now being squeezed as the strong CAD effectively reduces revenues on his U.S. lumber shipments. However, this isn't all bad news for Canadians as more of their company debt is now denominated in USD, so debt repayment is less of a burden.

Canadian mills can respond to the stronger CAD by investing to cut costs, looking for alternative markets where the strength of the CAD is less onerous, and if demand permits, they will attempt to get a bit more for their lumber to compensate for the weaker U.S. dollar. The last option, negotiating a "currency premium" or surcharge, only works in strong markets where U.S. importers are having difficulty obtaining adequate supply. Finding markets alternative to the U. S. is a viable option for European and South American lumber producers but not realistic for Canada as 60 percent of their lumber production and over 90 percent of their lumber exports go to the U.S. However, if the USD remains weak for an extended period of time, some Canadian producers will curtail production as higher cost mills become unprofitable when shipping to the U.S. That is now happening throughout Canada—a consequence of lower lumber prices and the

stronger CAD. Ultimately, U.S. lumber prices will respond as supply to the U.S. market decreases—the degree of response will depend on demand. Of course, this can be a double-edged sword. Less lumber may be exported to the U.S., which increases prices and costs to the U.S. component manufacturer. However, U.S. importers of Canadian trusses and components may be forced to pay more to compensate for the weaker USD, therefore making U.S. made components more competitive. Furthermore, a weaker USD will make U.S. components more competitive in Canada.

CONCLUSION

Exchange rates can have a profound impact on component manufacturers through their impact on the economy, interest rates, housing activity, and trade flows between the U.S. and other countries. For a variety of reasons, most analysts expect the USD to continue trending lower over the next two years. The CAD is expected to peak near 1.2 CAD/USD by the end of 2005. U.S. component manufacturers should plan for the possibility of a potential drop in Canadian SPF (spruce-pine-fir) shipments (depending on how the duty issue plays out and U.S. demand of course). That means if you are a heavy SPF buyer, it may be prudent to identify some alternative sources of supply as a hedge. At the same time, U.S. CMs should be looking for export opportunities in Canada and elsewhere, thereby taking advantage of the weaker USD. Finally, CMs should be monitoring inflation and interest rates as a weaker dollar will eventually affect both, and this will impact both residential and commercial construction markets.

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[1]This is simply an introductory article to exchange rates. As such, we are only providing a basic coverage of how they are determined, factors affecting exchange rates, and winners and losers. We won't discuss in detail the concept of "purchasing power parity"—a theory that says in the long run, exchange rates should move toward rates that would equalize the prices of an identical basket of goods and services in any two countries. For example, the "Big Mac Index" is a popular metric used to compare the price of a Big Mac in U.S. dollars all over the world. The Big Mac costs more in Europe ($3.28 versus $2.90 in U.S.), so the Euro is said to be overvalued. In contrast, the Big Mac costs only $1.26 in China, so the Yuan is said to be undervalued. China pegs the Yuan to the USD (by buying U.S. T-Bills and Bonds thus increasing demand for USD which strengthens the USD versus the Yuan), insuring the Yuan remains undervalued thus making Chinese exports cheaper to American consumers. Other countries also manipulate their exchange rates to favor trade with other countries, so exchange rates are not determined in a purely competitive environment defined to be a large number of small sellers and buyers. Governments play a large role as buyers and sellers.

Al Schuler works for Forestry Sciences Lab in Princeton, WV. Please note that the economic information/opinions contained in this article are not necessarily those of the USDA Forest Service. Dr. Schuler can be reached at 304/431-2727 or aschuler@fs.fed.us.

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