The internationalization of Quebec SMEs: exchange rate issues

When an entrepreneur operates internationally, that business is exposed to foreign exchange risk. Foreign exchange risk, or currency risk, is considered a major obstacle to export growth, especially as exchange rates have been more volatile in the last few years. With subdued growth outlooks in Quebec and Canada, Quebec businesses will have to look to international markets to expand. Hedging instruments exist to lessen the impact on businesses of short- and medium-term currency fluctuations. To shield themselves from longer-term movements, businesses can also improve productivity, and become part of global value chains. Diversifying export markets is critical for Quebec businesses. The free trade agreements Canada has entered into promote such diversification. However, to get the most out of them, businesses have to incorporate currency risk management into their development strategies.

In recent decades, emerging and developing nations have become very active players in the international landscape. Because their production costs are significantly lower than in advanced economies, emerging and developing nations have proven to be serious competitors.

Numerous Quebec businesses have fallen victim to the new competition, or decided to move out of the global market to focus on the Canadian market. The number of establishments engaged in international exports has declined.1 However, growth outlooks promise to be limited in Quebec and Canada for the next few years due to changing demographics and certain structural factors.2 As a result, international markets are Quebec businesses’ main source of growth. These businesses must therefore be encouraged to internationalize.

In addition to accessing a larger market, internationalization provides firms with an array of other advantages, particularly in terms of reducing production costs and knowledge sharing.3 It also involves costs and numerous risks; the primary risks are listed in box 1 on page 2.

This study focuses on currency risk: according to some surveys of Canadian businesses, it is the primary obstacle to export growth.4 Yet many businesses do not manage this risk. This study is intended to make entrepreneurs aware of currency risk and spotlight the various means available to lessen the negative impacts on their businesses of exchange rate fluctuations.

E VolutioN oF tHE CANADiAN DollAr's EXCHANGE rAtE oVEr tiME

Graph 1 on page 3 depicts the evolution, since the floating exchange rate system was reintroduced in 1970, of the bilateral Canada–U.S. exchange rate and the effective Canadian dollar exchange rate, which is a weighted average of bilateral exchange rates for the Canadian dollar against

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1 Source: Exporter Register, Statistics Canada. Between 2006 and 2009, the number of export establishments declined 10%.


Box 1
The risks of internationalization

All companies face an array of risks. Companies with international operations are, among other things, faced with specific risks. The main risks are summarized below.

Currency risk – All international activities involve currency risk. Exchange rates fluctuate, generating uncertainty about the revenue and expenses associated with companies’ international activities.

Economic risk – This risk refers to the economic events that can occur in foreign markets, disrupting demand for the company’s products: higher inflation, real estate slump, recession, etc.

Political risk – Social upheaval, strikes, geopolitical conflicts and corruption are among the risks that can disrupt a company’s sales or supply abroad. Imposing an embargo is another example.

Legal risk – There are two kinds of legal risk. There is legal risk associated with the chance that a foreign country will change its product regulations, requiring the company to make modifications or request new authorizations. There is also legal risk arising from contracts with foreign clients, such as the fees incurred abroad to enforce a contract.

Taxation risk – Higher duties and taxes can make products more expensive in foreign markets, penalizing the company’s competitiveness. Taxation risk also covers changes that may be made to tax benefits and subsidies, and any other change to the other country’s tax regime.

Commercial risk – Putting a product on the market always carries its own share of risks, such as the risks involved in assessing demand, price setting, marketing, and evaluating the competition. When they occur elsewhere, the risks intensify, because it is harder to assess customers’ needs and tastes and the state of the competition abroad than it is at home.

Transport risk – Selling merchandise abroad increases the risks associated with transport, such as breakage, loss, theft, vandalism, accidents, and so on. Also, when taking merchandise across borders, burdensome customs formalities or incomplete documents can cause delays.

Counterfeit risk – In some countries, it is difficult to enforce intellectual property rights. Foreign competitors can copy a product or its components and then manufacture them at a lower cost.

Supplier and customer risk – Risks always surround transactions with the company’s suppliers and customers, but geographic distance, language barriers and cultural differences increase such risks tenfold. Assessing the solvency of commercial partners, for example, or making sure they are honest can be a problem.
the currencies of Canada’s major trading partners. The two exchange rates move in tandem, which is normal given the importance of the United States in Canada’s trade: about three quarters of Canadian exports go to the United States, and just over half of our imports come from there.

In the 45 years from 1970 to 2015, the Canadian dollar went through four major depreciation cycles (shaded areas in graph 1) and three major periods of appreciation. In the last 13 years, exchange rate movements have accelerated and intensified. From January 2002 to November 2007, a period of just 70 months, the Canadian dollar rose 65% against the greenback; subsequently, during the financial crisis and recession, it depreciated by 25% in just 16 months (table 1). The loonie then made up the lost ground, but started to trend down again in September 2012.

Sources of Currency Fluctuations

Commodity prices and interest rate spreads

Canada has a floating exchange rate policy. This means that the Canadian dollar fluctuates based on supply and demand for the currency. Supply and demand are influenced by many factors; the most critical factors are commodity prices, particularly crude oil prices, and interest rate spreads between Canada and its primary trade partner, the United States.

When commodity prices go up, the value of Canada’s commodity exports also rises. This increases demand for the Canadian dollar, as foreigners will need more of them to pay Canadian producers. Conversely, if commodity prices decline, the Canadian dollar depreciates. Graph 3 on page 4 depicts the extent to which oil price fluctuations are a primary source of Canadian dollar depreciation.

Table 1 – Length and scope of the loonie’s primary depreciation and appreciation movements against the U.S. dollar from January 1970 to March 2015

<table>
<thead>
<tr>
<th>Movement</th>
<th>Start</th>
<th>End</th>
<th>Number of months</th>
<th>Percent depreciation or appreciation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Depreciation</td>
<td>January 1977</td>
<td>January 1986</td>
<td>108</td>
<td>-28%</td>
</tr>
<tr>
<td>Appreciation</td>
<td>January 1986</td>
<td>October 1991</td>
<td>69</td>
<td>+25%</td>
</tr>
<tr>
<td>Depreciation</td>
<td>October 1991</td>
<td>January 2002</td>
<td>123</td>
<td>-30%</td>
</tr>
<tr>
<td>Appreciation</td>
<td>January 2002</td>
<td>November 2007</td>
<td>70</td>
<td>+65%</td>
</tr>
<tr>
<td>Depreciation</td>
<td>November 2007</td>
<td>March 2009</td>
<td>16</td>
<td>-25%</td>
</tr>
<tr>
<td>Appreciation</td>
<td>March 2009</td>
<td>September 2012</td>
<td>42</td>
<td>+32%</td>
</tr>
<tr>
<td>Depreciation</td>
<td>September 2012</td>
<td>March 2015</td>
<td>30</td>
<td>-22%</td>
</tr>
</tbody>
</table>

Sources: Datastream and Desjardins, Economic Studies
source of substantial fluctuations for the loonie, as oil is one of Canada's primary export commodities. Such fluctuations are frequently unpredictable: the recent plunge by crude oil prices had not been anticipated before it materialized in the fall of 2014.

Interest rate spreads between trade partners also affect currency values. When interest rates go up in the United States while remaining stable or declining in Canada, demand for U.S. securities increases at the expense of demand for Canadian securities. This results in less demand for the Canadian dollar and more for the U.S. dollar, and the loonie depreciates.

Expectations of widening or narrowing interest rate spreads therefore have an impact on the exchange rate. These expectations depend on numerous factors, such as diverging growth outlooks in the two countries, forecast inflation growth, or the condition of public finances. Currently, for example, growth outlooks are better in the United States than they are in Canada. The Bank of Canada (BoC) lowered its key rate in January to mitigate the adverse impact on the Canadian economy of tumbling oil prices. For its part, in the United States, the Federal Reserve should soon raise its interest rate, as the U.S. economy has strengthened and it has a good growth outlook. Analysts therefore expect the spread between Canadian and U.S. interest rates to widen, putting downside pressure on the value of the loonie against the greenback.

Currency war
Currency depreciation stimulates a country's economy by encouraging exports and discouraging imports. In principle, a country with a floating exchange rate policy allows its currency to fluctuate with supply and demand shifts and does not try to influence it.

In recent months, a number of countries have eased their monetary policies by lowering interest rates or injecting liquidity into their financial systems. The European Central Bank and Bank of Japan did so to stimulate anaemic economies and stave off deflation. Other countries like Canada and Australia lowered their key rates to mitigate the negative impacts of falling commodity prices on their economies (oil, in Canada's case).

Since the start of 2015, more than 20 countries have adopted monetary easing policies, reviving fears of a currency war. In fact, some countries may have adopted such policies in order to bring down the value of their currency and make them more competitive in the international market, prompting competitors to act likewise in order to protect market share.

Many countries do not have much room to manoeuvre to kick start their economies. In many cases, interest rates are at the floor, and turning to budgetary policy is inappropriate given the elevated public debt. In this context, weakening the currency may seem like the last way to stimulate the economy. Although a country can rely on depreciating its currency to stimulate exports in the short term, it quickly loses that competitive edge if other countries follow suit. For example, the euro has depreciated just about as much as the yen against the U.S. dollar since October 2014, so Japan is no more competitive in the U.S. market than it was compared with euro zone countries six months ago.

On the other hand, the euro and yen exchange rates against the greenback have fluctuated wildly during this time. The yen and euro depreciation probably do not result from an official currency war, but the example shows that the main result of a currency war would be to increase exchange rate volatility substantially.

International financial instability
Periods of financial instability also create a lot of currency volatility because of the uncertainty they generate. During the 2008 financial crisis and the recession that followed in 2009, many countries saw extensive effective exchange rate volatility. Sitting at 0.39% from 2000 to 2007, the average daily fluctuation in the yen's exchange rate climbed to 0.70% between 2008 and 2009 (graph 4 on page 5).

Similarly, during the European sovereign debt crisis that lasted from the end of 2009 to the end of 2011, the euro's
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www.desjardins.com/economics

The exchange rate was highly variable. Bilateral exchange rates for the euro against the U.S. dollar, pound sterling, yen and Swiss franc were more volatile during this period than they were prior to the 2008 financial crisis (graph 5).

Exchange rate volatility intensifies during periods of financial instability due to such things as the safe haven effect: investors abandon the assets of the country that is in crisis, fleeing to more secure assets. Because U.S. investments are often considered secure, the greenback is a core safe haven. However, this can change with the times and events.

While financial instability is a source of currency fluctuation, exchange rate volatility can, in turn, be a source of financial instability. G-20 finance ministers and central bankers believe that currency volatility is a challenge for the global economy. For example, a substantial portion of some countries’ debt is denominated in a foreign currency, increasing their risk of default when that currency appreciates.

GOVERNMENT INVOLVEMENT

The exchange rate fluctuations that stem from shifts in currency supply and demand are normal in a floating regime. On the other hand, the fluctuations triggered by a currency war or financial instability are not desirable. Governments can help lessen fluctuations by encouraging greater inter-country collaboration on exchange rate policy, to prevent currency wars. Governments must also put pressure on countries that control their exchange rates and thus generate global trade imbalances. When such imbalances deepen, they increase the risk of a chaotic correction, characterized by abrupt adjustments to exchange rates and the imposition of risk premiums on a wide array of financial assets.

Furthermore, countries that need structural reforms must be encouraged to implement them, rather than turning to currency depreciation to stimulate their economies.

Lastly, each government should ensure sound management of the public finance in its own country. By doing so, they would help maintain international financial stability, which would reduce exchange rate volatility.

RISKS ASSOCIATED WITH CURRENCY FLUCTUATION

A floating regime generates microeconomic risks, as currency movements affect business competitiveness and profitability. The main negative impacts of currency fluctuations on business are:

• A rise by the dollar makes export firms less competitive in international markets, and lessens the competitiveness of local businesses that are facing greater competition within the country.

• Prices of export products are usually set in foreign currencies. Due to exchange rate movements, the amount of Canadian dollars exporters get may be quite different from what they expected to receive when they set their prices. A rise by the Canadian dollar would translate into a shortfall with respect to projected revenue.

• Prices of imported products are also expressed in foreign currencies. Accordingly, Canadian dollar depreciation pushes costs up for Canadian importers.

• The two above risks are risks that are associated with a firm’s commercial transactions. The same risks exist for financial transactions: depending on exchange rate movements, a company that takes out a loan abroad may have to pay more in Canadian dollars than anticipated for debt service and repayment; a company that has invested in a foreign financial asset could see smaller gains than expected (also in Canadian dollars).

Sources: Datastream and Desjardins, Economic Studies

7 www.g20.utoronto.ca/2015/150417-finance.html.

Currency risks are exacerbated by the unpredictability and volatility of this variable. In the space of a few months, a company’s bottom line can tilt in either direction, depending on the currency’s trajectory.

Because of the competitive edge it gets from currency depreciation, we tend to think that it is in the best interest of a country to have its currency low. That is not necessarily the case. Currency appreciation also has some advantages. It reduces the cost of consumer goods and imported inputs, as well as the costs of machinery and equipment from abroad. It therefore benefits companies that import inputs and machinery, as well as consumers.

Having a floating exchange rate also allows an economy to get back to equilibrium faster if it slows or accelerates too much. For example, when the economy is running faster than normal and the central bank raises interest rates to rein in demand, the dollar goes up, which also helps slow growth to a less inflationary level. Then interest rates do not have to be raised as much to get the economy back to equilibrium. A floating exchange rate regime therefore also has macroeconomic advantages.

**SOLUTIONS AVAILABLE TO BUSINESS**

Using foreign currency hedges

There are techniques and instruments for managing the currency risk companies face. The organizations whose mission it is to support firms that operate internationally provide small and mid-sized businesses with information and advice on this matter. A few years ago, Export Development Canada (EDC) released a guide to support businesses in developing a foreign exchange policy.

Briefly, currency risk management is a four-step process:

1. Define and measure the firm’s exchange rate exposure
2. Develop a company policy on currency risk
3. Hedge the risk through transactions or other techniques
4. Regularly evaluate and adjust

There are essentially two types of hedge: the natural hedge and the financial hedge. A natural hedge involves achieving as good a match as possible between revenue and expenses in the same foreign currency. This technique could suit companies that get some of their inputs from the same country they export products to. A company that finances operations with a loan denominated in a trade partner’s currency, for example, also benefits from a natural hedge.

A financial hedge is created using currency hedge instruments that a company can purchase from a financial institution. Among them, the best known and most used are currency futures, currency options and currency swaps (box 2 on pages 7 and 8).

Managing currency risks using hedging techniques and instruments is not simple. According to EDC surveys, export firms think that currency risk is the main obstacle to export growth. Yet a large proportion of them have no protection from this risk, primarily invoking a lack of internal resources and knowledge and the costs of hedging instruments to explain their behaviour. Under these circumstances, it is not surprising that fewer small businesses manage their currency risk than mid-sized and large businesses.

Moreover, nearly 20% of exporters who do not manage currency risk stated that they thought hedging instruments were overly speculative. At the very least this is a contradictory argument: by not protecting themselves, entrepreneurs are hoping that the exchange rate will be stable or tip in their favour. That is a very speculative attitude.

Currency hedges must not be used for speculation. On the contrary, entrepreneurs must accept the possibility that their strategy could result in foregoing the benefits of a future change in exchange rates that would be advantageous to them.

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9 Note that the exchange rate’s contribution to monetary policy effects depends on the country’s openness to international trade.


Box 2
Some uses of hedging instruments

Example 1
A currency futures contract is a commitment between two parties to buy or sell an amount of foreign currency at a predetermined date and rate.

An exporter is to receive US$100,000 in six months. Expecting the Canadian dollar to eventually rise, the exporter decides to protect himself with a currency future.

On a spot basis (at today’s rate), the Canadian dollar is worth US$0.8000. The 6-month futures price is US$0.8028.

The exporter is therefore pledging to sell his US$100,000 in six months at a rate of US$0.8028, established today, no matter what the dollar does.

After six months, converting his US$100,000 will yield C$124,564.03 (100,000/0.8028).

If the Canadian dollar appreciated 10% during the 6-month period, the Canadian dollar exchange rate at term would have been US$0.8800 and he would have received C$113,636.36, 8.8% less than the amount he received with the futures contract. On the other hand, if the Canadian dollar had depreciated 10%, he would not have benefited at all.

Example 2
A currency option provides the holder with the right to buy or sell a given amount of foreign currency at a predetermined date and rate. The buyer pays a premium to get this right. The amount of the premium depends on a number of factors, including the option’s term, the amount of protection the buyer wants from the market rate, forecast volatility, and the amount to hedge. The premium is not refundable, regardless of whether the option is exercised.

The exporter in the previous example, who is to receive US$100,000 in six months, decides to hedge against potential loonie appreciation by purchasing a currency option.

On a spot basis (at today’s rate), a Canadian dollar is worth US$0.8000. He buys a put (sell) option for US$100,000 that matures in six months, at an exercise price of US$0.8200 and a premium of C$1,100.

Six months later, the Canadian dollar has risen against the greenback, and the exchange rate is US$0.8800. Without hedging, he would have gotten C$113,636.36 (100,000/0.8800) for his US$100,000. If he exercises his option, he will get C$121,951.22 (100,000/0.8200) instead.

If the Canadian dollar had depreciated 10% during the six months, he would simply not have exercised his put option. Instead, he would have converted the US$100,000 at an exchange rate of US$0.7200, yielding C$138,888.89 (100,000/0.7200).

Example 3
A currency swap consists of two opposite transactions that are done simultaneously for the same amount.

Our same exporter, who is to receive a payment of US$100,000 in six months, needs the money now to pay suppliers. He decides to do a currency swap.

He buys US$100,000 at the current exchange rate and sells it using a 6-month futures contract. On one hand, he gets the money he needs right away and, on the other, he shields himself from a potential rise by the Canadian dollar (as shown in the futures example).
While it is true that there is a cost to actively managing currency risk, especially when rates are very volatile, not doing so can be much more costly. Any company that is exposed to such a risk should take the time to estimate the costs and benefits associated with hedging instruments before making a decision for or against them.

Improved productivity

Even if companies use the best currency hedging techniques and instruments that are most appropriate for their situation, they still cannot shield themselves from long-term currency trends. Surviving such trends requires other strategies. There are several options for dealing with the effects of long-term Canadian dollar appreciation or depreciation on their bottom line.

Between the last quarter of 2003 and first quarter of 2005, the BoC used its Business Outlook Survey to ask participating businesses about how they were reacting to the Canadian dollar surge that was then occurring. As table 2 from the article published on the matter shows, their reactions were wide ranging.

<table>
<thead>
<tr>
<th>Instrument</th>
<th>Advantages</th>
<th>Drawbacks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Currency future</td>
<td>. No initial outlay required</td>
<td>. Does not capitalize on favourable currency movements</td>
</tr>
<tr>
<td></td>
<td>. Hedges against unfavourable currency movements</td>
<td></td>
</tr>
<tr>
<td>Currency option</td>
<td>. Hedges against unfavourable currency movements while capitalizing on favourable currency movements</td>
<td>. The premium must be paid regardless of whether the option is exercised</td>
</tr>
<tr>
<td>Currency swap</td>
<td>. No initial outlay required</td>
<td>. Does not capitalize on favourable currency movements</td>
</tr>
<tr>
<td></td>
<td>. Resolves problems with the synchronization of foreign currency flow while protecting from unfavourable currency movements</td>
<td></td>
</tr>
</tbody>
</table>

Sources: Caisse centrale Desjardins and Desjardins, Economic Studies

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<table>
<thead>
<tr>
<th>Responses</th>
<th>Q1 2005*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Raise prices</td>
<td>21%</td>
</tr>
<tr>
<td>Lower labour costs</td>
<td>18%</td>
</tr>
<tr>
<td>Move inputs/processing abroad</td>
<td>25%</td>
</tr>
<tr>
<td>Other means to improve productivity/reduce costs</td>
<td>38%</td>
</tr>
<tr>
<td>Reduce capital spending</td>
<td>11%</td>
</tr>
<tr>
<td>Increase hedging</td>
<td>16%</td>
</tr>
<tr>
<td>Other**</td>
<td>32%</td>
</tr>
<tr>
<td>None</td>
<td>41%</td>
</tr>
</tbody>
</table>

* Responses do not sum to 100 because firms may have taken several actions; ** This category included measures to introduce new products, reorient sales strategies and change invoicing currency. It also included reductions in capital spending, moving inputs abroad, and changes in hedging practices.

Sources: Bank of Canada and Desjardins, Economic Studies

It is interesting to note that improving productivity through measures other than cutting labour costs was the most widespread response of the companies that were reacting to the Canadian dollar’s rise. True, it is difficult to raise prices when competition is intense; moreover, most businesses generally see slashing labour costs—either by cutting staff or limiting compensation—as a last resort solution.

Although it seems like an appropriate response to currency appreciation, enhancing productivity should also be seen as a form of prevention. In fact, the most productive—and therefore most competitive—businesses are clearly in a better position than their competitors to deal with currency fluctuations. With a more efficient cost structure, they are more profitable and can therefore absorb currency shocks without putting the company’s survival on the line.

Increased innovation would also help Quebec businesses perform well internationally, particularly because companies in advanced economies must henceforth focus on value-added products to stay competitive. It is very difficult for them to compete with emerging nations in mass production, because emerging nations have a competitive edge that is hard to beat in terms of production costs, particularly wages.

Productivity improvements often come through investing in machinery and equipment, much of which is imported. It would therefore be wise for businesses to capitalize on times when the loonie is high to invest in production equipment.

Supply chain optimization and participation in a global value chain

Many of the businesses surveyed by the central bank modified their supply chains in response to the loonie’s rise. Some turned to foreign suppliers, particularly suppliers in emerging nations that provided inputs at advantageous costs. Others operated more extensively abroad. Frequently, they moved simple production processes to emerging economies and kept production involving more value added, such as design and marketing, in Canada.

Note that the loonie’s rise in the first decade of the century coincided with emerging nations’ expansion, allowing Canadian businesses to acquire much cheaper inputs while capitalizing on an exchange rate that was favourable to imports.

By increasing the proportion of imported inputs or shifting some production abroad, businesses reacted to the loonie’s rise by increasing their natural hedge. Similarly, participating in a global value chain may give a business some protection from currency fluctuations by increasing its natural hedge. Essentially, a company that is part of a value chain specializes in a specific part of the production process for which it has proven efficiency. In global value chains, businesses are often vertically integrated, meaning that they import intermediate goods for manufacturing goods that are then exported. This process increases the chances that the company will have a natural hedge that protects it from currency fluctuations.

MARKET DIVERSIFICATION AND CURRENCY RISK

As mentioned in the introduction, some factors, including population ageing, suggest that Canada will see limited economic growth in the coming years. As a result, international markets will be Quebec businesses’ main source of growth.

For Quebec exporters, the U.S. market is a sure thing because of its geographic proximity, and its cultural and social similarities, as well as similarities in its trade law, making it easy for local businesses to access. Europe, though not as close as the United States, still has many affinities with Quebec. After the United States, the countries of European Union are Quebec’s second largest export market (table 3 on page 10). Emerging nations, where the middle class’s standard of living is rising steadily, offer very promising growth potential for Quebec exports. For businesses, the key to success is therefore further diversification of their international client base. Without turning away from traditional markets, they should consider the possibility of broadening their trade partner base and including emerging nations.

The diversification process is underway: between 2000 and 2014, the U.S. share of Quebec’s total exports fell from 86% to 70%, while the portion of exports going to countries in European Union went from 9% to 12%. The share of BRIC countries (Brazil, Russia, India and China) rose from 1.1% to 5.7% (table 3 on page 10). The “other countries” category, which also expanded substantially during this time, includes a great many emerging markets in Asia and Latin America.

Diversifying a business’s export markets can reduce the economic risk it is vulnerable to. In fact, a drop in demand for its products that results from an economic slowdown

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14 The results of the survey must be interpreted with caution given the small sample size.

15 A value chain includes all of the stages needed to produce a good or service and deliver it to the customer, from conception to final use. When these activities are handled by a variety of companies worldwide, it is called a global value chain.
experienced by one of its trade partners could be offset by a rise in demand stemming from faster economic activity for another partner.

On the other hand, a company with several international trade partners is more vulnerable to foreign exchange risk, since it must carry out transactions involving numerous currencies. It could gain some natural protection if its trade partners’ exchange rates were negatively correlated. However, selecting export markets based on exchange rate correlations is not a reliable strategy, as this parameter is affected by economic, structural, social and geopolitical factors.

Furthermore, some countries, whether emerging or not, are more subject to financial instability, which can eventually result in greater currency volatility and increase the foreign exchange risk to which their trade partners are exposed. A country can fall victim to financial instability for a whole array of reasons, including public debt and its political situation. Although these risks can be controlled by looking at a country’s economic and political situation before doing business there, unforeseen events can happen anywhere in the world, even in countries that were thought to be safe from upheaval.

In other words, companies that want to further diversify their export markets must deal with greater currency risk, and therefore view managing currency risk as nearly essential to their success.

SUPPORT FOR BUSINESSES Information, training and financial assistance
Managing currency risk is an integral part of major exporters’ strategy. The small and mid-sized enterprises (SMEs) that constitute 99% of all Quebec businesses do not always have the human and financial resources they need to do so.\(^\text{16}\) As a result, they may be averse to the idea of diversifying their export markets out of fear of greater exposure to currency risk.

One way to encourage Quebec SMEs to diversify their client bases geographically is to help them manage that risk. First and foremost, they must be made aware of the issue. Many businesses rejected the possibility of using hedging instruments out of hand, without even looking at the costs and benefits. Note that it is not an easy evaluation to do. They no doubt need support with this very first step.

A number of organizations—government agencies, business associations and financial institutions—offer support to business in the form of information and training in the area of currency risk management. Governments also offer financial assistance. Through Investissement Québec, for example, the provincial government offers a tax credit for diversifying Quebec manufacturers’ markets; a company could dedicate some of this financial help to developing a foreign exchange policy.\(^\text{17}\)

Free trade agreements
The free trade agreements concluded between the Canadian government and other nations favour the diversification of Quebec companies’ export markets. Such agreements give businesses numerous competitive advantages, for example by reducing or eliminating tariff and non-tariff obstacles and providing privileged access to the trade partner’s market. These advantages can be weighty enough to convince

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businesses to expand their operations geographically, despite the currency risk.

Some advantages of free trade agreements can even help reduce the currency risk businesses are exposed to. Because of the open access to the European market it will provide, the Comprehensive Economic and Trade Agreement (CETA) between Canada and the European Union could help Canada carve out more space in the global economic landscape. More Canadian businesses could therefore participate in global value chains. As discussed earlier in this study, participating in a global value chain may give a business some protection from currency fluctuations by increasing its natural hedge.

Canada has about a dozen free trade agreements to its name, with several others being negotiated, including some with emerging nations such as India (box 3 on page 12). To get the most out of the growth potential the new agreements will provide, however, Quebec SMEs will have to make currency risk management part of the company’s expansion strategy.

CONCLUSION

To expand, Quebec businesses will have to be increasingly focused on international markets in the coming years. This will make them more vulnerable to specific risks, including currency risk. Exchange rates fluctuate a lot, and often unpredictably. A company that is operating internationally could quickly see profitability erode if it does not protect itself from these fluctuations.

For some businesses, especially small ones, managing currency risk may seem expensive and complicated. However, having a currency policy may pay off handsomely. Numerous public and private organizations provide support to businesses that want to acquire such a policy.

Also, to succeed internationally, the focus must be on productivity. The more productive businesses are, the more equipped they are to deal with headwinds such as unfavourable currency movements. Lastly, businesses can adopt strategies—modifying their supply chains or joining a global value chain—that will help them offset the impact of currency fluctuations on their business.

Quebec businesses must be encouraged to diversify their client bases in terms of geography. Without neglecting traditional markets, they must look at the possibility of making greater inroads into emerging nations, which are very promising opportunities for their exports. Businesses that incorporate currency risk management into their expansion strategy and have a good grasp of the principles will certainly have an easier time breaking into such markets and ensuring their longevity.

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### Box 3
**List of Canada’s free trade agreements**

**Free trade agreements now in force**
- Canada–Korea ⇒ Effective date: January 1, 2015
- Canada–Honduras ⇒ Effective date: October 1, 2014
- Canada–Panama ⇒ Effective date: April 1, 2013
- Canada–Jordan ⇒ Effective date: October 1, 2012
- Canada–Colombia ⇒ Effective date: August 15, 2011
- Canada–Peru ⇒ Effective date: August 1, 2009
- Canada–European Free Trade Association ⇒ Effective date: July 1, 2009
- Canada–Costa Rica ⇒ Effective date: November 1, 2002
- Canada–Chile ⇒ Effective date: July 5, 1997
- Canada–Israel ⇒ Effective date: January 1, 1997

*North American Free Trade Agreement (NAFTA)* ⇒ Effective date: January 1, 1994

**Free trade agreement negotiations concluded**
- Canada–European Union: *Comprehensive Economic and Trade Agreement (CETA)* ⇒ August 5, 2014

**Free trade agreement negotiations underway**
- Canada–Guatemala, Nicaragua and El Salvador
- Canada–India
- Canada–Japan
- Canada–Caribbean Community (CARICOM)
- Canada–Morocco
- Canada–Dominican Republic
- Canada–Singapore
- Canada–Trans-Pacific Partnership
- Canada–Ukraine
- Modernization of the Canada–Costa Rica free trade agreement
- Modernization of the Canada–Israel free trade agreement

**Preliminary talks**
- Canada–Turkey exploratory trade discussions
- Exploratory discussions for a Canada–Thailand free trade agreement
- Canada–Southern Common Market (Mercosur) exploratory trade discussions

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