DEALING WITH THE EVER-CHANGING VALUE OF THE U.S. DOLLAR

The Dilemma...The U.S. dollar has always changed—and will continue to change—in value. So it’s important to have a grasp on what the dollar will be worth tomorrow, next month, next year, or in the next decade. How does one manage the impact of the changing value of the dollar—or any currency, for that matter?

THE STORY
The history of the U.S. dollar is simple, yet not well known. Today the U.S. dollar is a “fiat” currency and is not supported by any physical asset. The word “fiat” means an authoritative decree, sanction, or order by a person or group of persons having the absolute authority to enforce it. In other words, the United States government, through its agent, the Federal Reserve Bank, orders the U.S. dollar bill (and all other denominations) to be “legal tender for all debts, public and private.” Put another way, the U.S. dollar represents value simply based on the confidence in the United States government and the United States economy. It is the full trust and belief in the power, trustworthiness, and reliability of the United States.

It is interesting to explore how we arrived at the value of the U.S. dollar as it stands today. In 1900, the U.S. government decreed that the U.S. dollar’s value be set at $20.67 per troy ounce of gold. Anyone holding $20.67 in valid paper currency notes could convert such notes into one ounce of gold. A physical asset, gold, supported the paper currency. Skip ahead through World War I and the Great Depression, to 1934, when the U.S. government devalued the dollar by 69% (wow!) and set the dollar’s value at $35 per ounce of gold. Then, fastforward through World War II, the Bretton Woods Agreement, the Korean War, and the Vietnam War, and into the early 1970s, when President Nixon decided to eliminate the convertibility of the U.S. dollar into gold altogether. That leaves the dollar, as it is today, 40 years later, no longer anchored to gold. Instead, the dollar is backed by confidence and trust in the United States.

With this history as background, let’s turn to some more immediate questions:
• Why does the dollar’s value fluctuate so dramatically in short periods of time and across different asset classes?
• How does one manage a business that is impacted by the ever-changing value of the dollar?
• What can be done to manage the risk associated with conducting business in global markets?

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THE PRACTICAL APPLICATION

For almost 40 years, the dollar, unsupported by a physical asset, has reigned as the international reserve currency, as the principal safe haven currency and as the standard unit of currency for most commodities. However, the value of the dollar has fluctuated consistently and, at times, significantly.

This volatility may be attributed in part to:
• The confidence in the United States at times of significant distress in the world
• The changing role of the dollar as a reserve currency for foreign central banks
• The confidence in the United States due to economic growth or contraction
• The short-term trade surpluses and deficits and the long-term capital inflows and outflows
• The short- and long-term prospects for inflation
• The short- and long-term fiscal and monetary policies of the United States
• The role of the financial speculator—pure and simple arbitrage

Every business, large or small, public or private, domestic or global, will always be affected by the changing value of the dollar. Its changing value reaches deeper and deeper into every business opportunity or challenge as the domestic U.S. economy integrates further and further with the global economy.

This global integration occurs continuously over long periods of time, and is almost unnoticeable when viewed on a monthly or quarterly basis. However, it has an enormous impact when examined over years and decades. What is noticeable is the fluctuating value of the dollar daily, weekly, and monthly.

The business impact of a fluctuating dollar can be monitored, forecast, and managed through a risk management hedging plan. This does not need to be a complex series of policies and procedures, but can simply (1) identify where the business is affected, (2) examine and forecast the sensitivity of the business, and (3) if appropriate, execute financial hedges (from a list of pre-approved hedging instruments).

It is important to keep in mind that the risk management plan is an evolving process, not a static document, and the plan should be consistently reviewed and updated as business circumstances change.

THE SOLUTION

What is the best way to develop a risk management plan for your business? What resources are available for assistance with the financial and market variables that will impact a risk management plan? What is the best way to identify the appropriate hedging instruments to use? What are the outcomes of an effectively implemented risk management plan?

PNC Bank, through its Capital Markets group and its Foreign Exchange advisory team, is committed to providing insight into these and other questions and to helping you make smart, well-informed decisions. We can assist you as you grow your business globally and help you develop an appropriate currency risk management plan to meet the goals of your organization.

PNC provides the resources and support to help companies develop an appropriate hedge policy in order to manage the complex business of foreign exchange. For more information, please contact your Foreign Exchange Specialist at 800-723-9106.

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