**VOLKSWAGEN’S HEDGING STRATEGY**

In January 2004, Volkswagen, Europe’s largest carmaker and until recently one of its most successful, reported a 95 drop in 2003 fourth quarter profits which slumped from €1.05 billion to a mere €50 million. For all of 2003, Volkswagen’s operating profit fell by 50 percent from the record levels attained in 2002. Although the profit slump had multiple causes, two factors were the focus of much attention – the unprecedented rise in the value of the euro against the dollar during 2003, and Volkswagen’s decision to hedge only 30 percent of its foreign currency exposure, as opposed to the 70 percent it had traditionally hedged. In total, currency losses due to the dollar’s rise are estimated to have reduced Volkswagen’s operating profits by some €1.2 billion ($1.5 billion).

The rise in the value of the euro during 2003 took many companies by surprise. Since its introduction January 1, 1999, when it became the currency unit of 12 members of the European Union, the euro had recorded a volatile trading history against the U.S. dollar. In early 1999 the exchange rate stood at €1 = $1.17, but by October 2000 it had slumped to €1 = $0.83. Although it recovered, reaching parity of €1 = $1.00 in late 2002, few analysts predicted a rapid rise in the value of the euro against the dollar during 2003. As so often happens in the foreign exchange markets, the experts were wrong, by late 2003 the exchange rate stood at €1 = $1.25.

One cause of this reversal in the value of the euro against the dollar was a record U.S. foreign trade deficit in 2003. The U.S. economy grew rapidly during 2003, sucking in imports from foreign nations while generating anemic economic growth. The result was a flow of dollars out of the United States into the hands of foreigners. Historically, foreigners had reinvested those dollars out of the United States, and the return flow had kept the dollar strong despite persistent trade deficits. This didn’t happen to the same extent in 2003. Instead, many foreigners sold the dollars they received for other currencies, such as the euro, Japanese yen, or British pound. They did this because they had become increasingly pessimistic about the future value of the dollar and were reducing their dollar holdings accordingly. Their pessimism was itself a function of two factors. First, U.S. government officials stated that they would prefer a weaker dollar in order to increase the competitiveness of U.S. companies in the global marketplace (the theory being that a falling dollar would make U.S. exports more competitive). With the government talking the dollar down, many foreigners decided to reduce their dollar holdings. Second, the U.S. government ran a record budget deficit in 2003, and this was projected to remain high for some time. Looking at this some foreigners concluded that the U.S. government might be forced to finance its spending by expanding the supply of dollars (i.e. by printing money), which would lead to inflation and reduce the value of the dollar even further. Thus, they sold dollars and purchased currencies thought to be less inflation prone.

For Volkswagen, which made cars in Germany and exported them to the United States, the fall in the value of dollar against the euro during 2003 was devastating. To understand what happened, consider a Volkswagen Jetta built in Germany for export to the United States. The Jetta costs €14,000 to make in Germany and ship to a dealer in the United States, where it sells for $15,000. With the exchange rate standing at around €1 = $1.00, the $15,000 earned from the sale of a Jetta in the U.S. could be converted into €15,000, giving Volkswagen a profit of €1,000 on every Jetta sold. But if the exchange rate changes during the year ending up at €1 = $1.25 as it during 2003, each dollar of revenue will buy only €0.80 (€1/$1.25), and Volkswagen is squeezed. At an exchange rate of €1 = $1.25, the $15,000 Volkswagen gets for the Jetta is now only worth €12,000 when converted back into euros, meaning the company will lose €2,000 on every Jetta sold (when exchange rate is €1 = $1.25, $15,000/1.25 = €12,000)

Volkswagen could have insured against this adverse movement in exchange rates by entering the foreign exchange market in late 2002 and buying a forward contract for dollars at an exchange rate of around $1= €1 (a forward contract gives the holder right to exchange one currency for another at some point in the future at a predetermined exchange rate). Called hedging, the financial strategy of buying forward guarantees that at some future point, such as 180 days, Volkswagen would have been able to exchange the dollars it got from selling Jettas from the U.S. into euros at $1 = €1, irrespective of what the actual exchange rate was at that time. In 2003 such a strategy would have been good for Volkswagen. However, hedging is not without its costs. If the euro has declined in value against dollar, instead of appreciating as it did, Volkswagen would have made even more profit per car in euros by not hedging (a dollar at the end of 2003 would have bought more euros than a dollar at the end of 2002). Also hedging is expensive because foreign exchange dealers will charge a high commission for selling currency forward. For whatever reason, Volkswagen decided to hedge just 30 percent of its anticipated U.S. sales in 2003 through forward contracts, rather than 70 percent it had historically hedged. The decision cost the company more than a €1 billion. For 2004, the company announced that it would revert back to hedging 70 percent of its foreign currency exposure.

*Sources: Mark Landler, ‘As Exchange Rates Swing, Car Makers Try to Duck,’ The New York Times, January 17, 2004, pp. B1, B4; N. Boudette, ‘Volkswagen Posts 95% Drop in Net,’ The Wall Street Journal, February 19, 2004, p. A3; and ‘Volkswagen’s Financial Mechanic,’ Corporate Finance, June 2003, p.1*