Foreign Exchange Risks for US Dollar Investors in Foreign Assets

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It is tempting to make debt and equity investments in foreign currency-denominated assets because, on the surface, these assets appear to give the investor a high rate of return. This is often not the case as I have found out the hard way—through experience— over the years. Several case studies will illustrate my findings.

GREEK REAL ESTATE IN DRACHMAS

Before 2002, Greece's currency was the Drachma. In 1982, my mother decided to buy an apartment in Rhodes, Greece to be near her sister in the summers. My father had died the year before. She was able to buy a nice three-bedroom apartment for about $60,000. I do not recall what the Drachma price was. Over the years, the value of the flat quadrupled in Drachma terms. In 1999, we decided to sell the apartment and were anticipating a massive gain on this investment. However, we had not taken into consideration that over those intervening years, the value of the Drachma had been gradually and steadily depreciating. For anyone living in Greece, the math was simple: the price of the apartment quadrupled which would have yielded a very nice capital gain. But the situation was different for my mother. When we sold the apartment and converted the Drachmas back to Dollars the capital gain was very small. What we bought in 1982 for $60,000 we sold in 1999 for $70,000.

When a US Dollar investor invests in a foreign currency, they are taking a foreign exchange risk. My mother was not only investing in real estate, she was unwittingly investing in the value of the Drachma. So what we gained in the real estate investment was pretty much offset by the decline in the value of the Drachma in Dollar terms.

Just remember this: When you as a dollar investor buy assets in a foreign currency, you are taking a currency risk. What seems like a high return is often illusory as this example clearly shows.

LOANS TO FOREIGN COMPANIES IN LOCAL CURRENCIES

Dollar investors may be fooled into thinking they can make a lot of money by making loans or buying bonds denominated in foreign currencies. These foreign currency loans may have significantly higher interest rates than Dollar rates. For the sake of simplicity, let us assume that you can buy a certificate of deposit in a highly rated US bank for say 4%. You may be tempted by the fact that you can buy a CD in a highly rated Brazilian bank in Brazilian REAL for 10%. You may view this as an easy way to make more money by taking a similar credit risk. Again, you are taking a currency risk. You are not only buying a CD, you are also betting on the value of the REAL. If the REAL depreciates against the Dollar you will not get all your principal back in Dollar terms. In fact, you may wind up losing money on the transaction.

Again: you must understand that you are taking a currency risk and it is for this reason that the rate you are getting on your investment is so high.

ANOTHER EXAMPLE–MEXICAN COMPANY LOANS IN USD

Back in the late 1970s, Mexican borrowers were able to borrow in USD at significantly lower rates than they could borrow in Mexican Pesos. I was involved in making these types of loans to government entities and highly rated Mexican companies. Then there was a massive depreciation of the Mexican Peso from something like 8 Pesos to the Dollar to 12 Pesos to the Dollar. As a result, the Mexican borrowers were in the following position: for every Dollar they owed to the US investors, they now had to come up with 12 Pesos instead of 8 Pesos. The accounting was simple: now the borrowers' loans were increased in value on the balance sheet by 50% (in pesos) and the offset to this was that the net worth of the borrower was decreased by the amount of the debt increase. This could have bankrupted the Mexican borrowers; but fortunately, the Mexican government stepped in and helped the Mexican borrowers by supplying funds by giving the borrowers tax credits for these losses.

Once again, we find a situation where the players do not take into consideration the currency risks involved. In this case, the borrowers were betting that the Mexican Peso would not be devalued; and the lenders were also making the same bet. The results could have been catastrophic.

FINAL EXAMPLE–INVESTING IN MULTINATIONAL COMPANIES

If you buy shares in a multinational enterprise, you are assuming that the dollar will not appreciate against the local currency. Let's say, for example, that Multinational Company XYZ has 75% of its business in Europe denominated in the Euro. If (say) the US Dollar appreciates against the Euro, the sales, profits, assets, liabilities and net worth of the enterprise will shrink in Dollar terms. Here is an example. Suppose the assets of the European part of the business amount to $100 million Euros. At current exchange rates (1 Euro = 1.04 USD) this means that the $100 million Euros in Dollar terms equals USD 104 million. Let us further assume that the Euro depreciates against the dollar such that one Euro now equals one USD. By virtue of this depreciation of the Euro, the USD amount of the assets has decreased by USD $4 million. The depreciation of the Euro (that is, the appreciation of the dollar) has reduced the effect of the European business on the company and then, presumably the value of the shares of the multinational company.

The lesson is clear: You as a US dollar investor should make sure you understand that you are taking foreign currency risks in transactions which, on the surface, look to be favorable. When you take the currency risks into consideration, the situation may not be as favorable as it appears to be on the surface.

These lessons seem to be relevant now because we seem to be in a period of a strong dollar.

Of course, if the dollar weakens, these risks will disappear in some cases. But in other cases (e.g., emerging markets) it is obvious that their currencies will weaken compared to the USD.

We need to keep one thing in mind: in 2000 the GDP of the Eurozone was basically equal to that of the US. Now, the GDP of the USA is roughly twice that of the Eurozone. As Warren Buffett once said that nobody makes money betting against America.

DON'T SELL THE DOLLAR SHORT

For more information, the reader is referred to "Top Dollar—Why the Dominance of America's Currency Is Harder Than Ever to Overturn" by Eswar Prasad in the July/August 2024 issue of Foreign Affairs Magazine (see https://www.foreignaffairs.com/united-states/top-dollar-currency-prasad).

One would think that with all the economic and political problems (unsustainable deficits continuing to increase with federal public debt now at 125% of GDP; and a government which too often flirts with defaulting on its debt) that the Dollar's position as the dominant currency would be in jeopardy. The author concludes however as follows: "The story of the Dollar is, ultimately, less about the United States' strength than about the rest of the world's weaknesses. Until that disparity changes, and seemingly no matter how badly the United States plays its cards, don't expect the Dollar to decline."

Here are some key points to keep in mind:

- At least half of all international trade is denominated in Dollars which is much greater than the U.S share of world trade of 11 percent.
- The Dollar is the principal reserve currency. 59 percent of foreign exchange reserves in the world's central banks are held in Dollar-denominated assets.
- Two-thirds of securities issued by corporations outside their home countries are denominated in Dollars.

All warnings by experts that the dollar will be eclipsed have been wrong. As the author states: "The Dollar remains firmly on its pedestal and above the fray." Bitcoin and other cryptocurrencies were thought to challenge the Dollar's dominance. "But with its highly volatile value, high transaction fees and limited capacity for handling large volumes of transactions, Bitcoin has been a terrible for payments."

The author adds that even chaos has benefitted the Dollar: "Any economic and geopolitical turmoil, even if unleashed by the United States, tends to lead investors worldwide to search for safety. And U.S. financial markets are the only ones large enough to meet their demands."

For the time being, the Dollar's dominance, going all the way back to the end of World War II, is not seriously being challenged.