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Billabong: The Impact of Exchange Rate on its Business

Introduction

Most businesses highly depend on interest rates to be profitable and Billabong case in no exception. The aim of this paper is to analyze the impact of AUD-USD exchange rate on it business viability. In the first section, a historical analysis of exchange rates between 2 countries is presented and a floating system is recommended to Australia monetary policy.

In the second section, the impact of exchange rates on trade and investment is exemplified. Finally, the effect of 3-way exchange rate changes on Billabong profitability is analyzed.

1a. Historical changes in the Australian-US dollar Exchange Rate

To simplify the analysis, this section considers 2 main points in exchange rate history between the two countries: a fixed exchange rate era (1944 -1983) and a floating system with devaluation generally depending on changes in trade and financial flows (1983-2018).

1. Fixed Exchange Rate Era (1944-1983)

After Bretton Wood Conference in 1944, Australia adopted its exchange rate system to link the Australian pound to the British pound. The AUD was born in 1966, but it was linked to USD in 1971 (Blundel Wignall, Fahrer & Heat, 1993). Different to other countries which participated in Bretton woods, Australian dollar exchange rate remained fixed until December 1983 (Parliament of Australia, 2018).

The fixed exchange rate system born in Bretton Woods saw all currencies linked to the dollar, and the dollar linked to gold. This fixed exchange rate system aimed to avoid the turbulent experience of the inter-war financial system due to competitive devaluations. To prevent speculation against exchange rates, capital flows were restricted in all countries, including Australia (Buttonwood, 2013). In Bretton Woods conference all countries committed not to use devaluation as a weapon of competitive trade policies. However, currencies could be defended by devaluations of up to 10% without any IMF approval (Hill, 2013).

During commodity prices boom (1972-1974) Australia's terms of trade rose, exacerbating inflationary pressures. Even the dollar was revalued 3 times, it was not enough to reduce inflation. In contrast, between 1974 and 1978 the terms of trade weakened. The crawling peg against USD since 1976 and relatively high inflation soon led to the impression that the AUD was overvalued, causing capital outflows. By early 1980s, inflation and speculation

continued reducing capital inflows. Finally, by 1983 the Government decided that a floating system would give greater control over monetary policy and reduce distortions in financial markets (Blundell Wignall, Fahrer, and Heat, 1993).

2. Floating System (1983-2018)

According to many experts and institutions, since 1983 4 main drivers affect the Australian- US dollar exchange rates:

- **The Perspectives for Global Growth**: When global growth is not expected, Australian dollar generally depreciates. The same occurs with increased volatility in financial markets. As US government bonds are globally considered a safe investment, when financial markets perceive increasing risk, the demand for those bonds and USD also tend to increase, depreciating the AUD. On the contrary, when global growth is expected and risk considered low, AUD usually appreciates.
- **Commodity Export Demand and Prices:** Australia heavily depends on commodities (especially iron, ore, and coal) exports for its economic well-being. A slowing demand of these products reduces their price and the need for Australian dollars. Consequently, the Australian dollar depreciates. On the contrary, when demand increases, prices rise, and the Australian dollar appreciates.
- **Interest Rates:** If Australia's interest rate increases compared to the American interest rate, the Australian dollar usually appreciates. But if American interest rates appreciates, the Australian dollar depreciates.
- **Performance of Asian Currencies and Economy:** More than 3/4 of Australia's exports go to Asia, and AUD is often used as a proxy for that continent. If Asian currencies depreciate, in general so does the AUD/USD exchange rate. The same occurs with their economic growth: If Asian economy grows, so does its demand for Australian resources. Hence, AUD appreciates (Commonwealth Bank, 2018).

Empirical evidence supports what already explained:

Source: Trading Economics

- **AUS Appreciation**: Between 2009 and 2012 China's economic growth was strong, being the largest contributor to world growth since the global financial crisis of 2008 (World Bank, 2018). China's high demand of commodities to support its development also raised commodity prices, especially iron (Reserve Bank of Australia, 2011). Interest rates also were high compared to the flat American ones, what increased FDI inflows into the Australian economy (Kohler, 2012).
- **AUS Depreciation**: Since 2012, the Australian dollar is losing value. Some of the reasons are the fall of commodity prices (Reserve Bank of Australia, 2018), the increase in American government bonds interest rate since 2016 (Letts, 2018) and the deceleration of China economic growth (National Australia Bank, 2018).

1b.Floating system for Australia

We strongly recommend Australia to maintain the floating system as it gives flexibility to the government.

Firstly, it enables the Reserve Bank to have **monetary policy autonomy**.As the Government do not have to worry about maintaining foreign exchange parity, the Government can use its monetary policy to contract or expand its economy, depending on domestic conditions (Hill, 2013).

Secondly, a floating exchange system would allow the government to **adjust its trade balance**.As already explained, Australia is highly dependent on external forces such as commodity prices, Asia

growth, and US interest rates. A floating exchange rate allows the country to mitigate the impact of those external shocks on its trade balance by appreciating or depreciating the Australian dollar (Reserve Bank of Australia, 2018).

2. Exchange Rate and Export/Investment Pricing (Appreciation/Depreciation)

Exporting to US

If AUD appreciates against USD, Billabong exports in the U.S. become more expensive for importers/buyers. If it depreciates, then Billabong products in U.S will be cheaper. With appreciation export price competitiveness declines for Billabong. If it depreciates, then export price competitiveness will surge, as Billabong can earn more AUD.

Example

Billabong Exporter	October 2008	October 2009
Exchange rate: A$1=	$0.60	$0.94
Revenue to Billabong for each Swimsuit exported from Australia is A$40	Price for US buyers $24	Price for US buyers $37.6
Revenue to Billabong for each watch exported from Australia is A$90	Price for US buyers $54 (Cheaper)	Price for US buyers $84.6
Export competitiveness declines	No	Yes
Exchange from USD to AUD	$1=A$1.66 (More Profit)	$1=A$1.06 (Less Profit)

Investing in US

If the Australian currency depreciates against USD, Billabong must invest more money in AUD. If it appreciates, Billabong must spend less amount in AUD, making the investment less expensive in Australian currency.

Example

Billabong Exporter	October 2008	October 2009
Exchange rate: A$1=	$0.60	$0.94
Export competitiveness declines	No	Yes
If Billabong wants to Invest $1 million in the U.S for exporting its products	Billabong must invest A$1.66 million = $1 million	Billabong must invest A$1.06 million = $1 million

3.Effect of 3-way exchange rate changes on Billabong profitability

Two different scenarios are presented to analyze the impact of appreciation and depreciation of Yuan, USD, and AUD in a 3-way exchange rate. In this case, 2007 is acting as the base year.

SCENARIO 1: CYN(Yuan) depreciates against USD and AUD depreciates against USD

	2007		2008		2007		2008
CYN/USD	6.71		7.5	AUD/USD	0.89		0.94
Amount worth of goods	1,000,000,000.00		1,000,000,000.00	Amount worth of goods	1,000,000,000.00		1,000,000,000.00
Goods	149,031,296.57		133,333,333.33	Goods	1,123,595,505.62		1,063,829,787.23
Difference		- 15,697,963		Difference		- 59,765,718	

SCENARIO 2:CYN(Yuan) appreciates against USD and AUD appreciates against USD

	2007		2008		2007		2008
CYN/USD	6.71		5.39	AUD/USD	0.89		0.79
Amount worth of goods	1,000,000,000.00		1,000,000,000.00	Amount worth of goods	1,000,000,000.00		1,000,000,000.00
Goods	149,031,296.57		185,528,756.96	Goods	1,123,595,505.62		1,265,822,784.81
Difference		36,497,460		Difference		142,227,279	

Conclusion:

1. Depreciation of CYN and AUS against USD result in a double gain for Billabong profitability. With the depreciation of CYN, Billabong earns USD 36.497 more compared to 2007 exchange rate. With the depreciation of AUD, Billabong earns AUD 142.227 more compared to 2007 exchange rate.
2. In contrast, appreciation of CYN and AUD against USD result in a double loss for Billabong profitability. With the appreciation of CYN, Billabong earns USD 16.697 less compared to 2007 exchange rate. With the appreciation of AUD, Billabong earns AUD 59.765 less compared to 2007 exchange rate.

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