

CHAPTER 10 – Measuring Exposure to FX Fluctuations

Dow Chemical to Use Only the Mark for All its Business Dealings in Europe.

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Dow Chemical Co., reacting to the chaos in European currency markets, said it will use German marks as the common currency for all its European business transactions.

Dow's move comes as Europe's bankers and politicians are deeply divided over the outlook for a single currency. It also echoes the widespread frustration among European businessmen who favor a single currency. However, no businessman contacted plans, as yet, to follow Dow's lead and embrace the mark.

The move shifts currency risks from Dow to customers who used to do business in other currencies, said Fernand Kaufmann, Dow's sales and commercial vice president for Europe. The move late last week also effectively raises prices in European markets where local currencies have been devalued. For that reason, it may not stick in light of the depressed World-wide market for chemicals and plastics, competing chemical companies said.

Dow's action anticipates the day when a single European currency will "benefit both manufacturers and customers in terms of simplification and fairness," Mr. Kaufmann said. Dow's new policy, for instance, would nullify any advantage that a Dow customer in one country might have over competitors in another country based on currency swings, he said.

Rivals took a more down-to-earth view of Dow's intentions. "We commend them for the attempt to raise prices in Europe," said John Fitzpatrick, assistant treasurer of Union Carbide Corp., Danbury, Conn.

Dow, which is based in Midland, Mich., said customers who buy polystyrene, polyethylene and urethane chemical products will continue to be billed in local currencies. But invoices will reflect prices set in marks. Dow said the move was aimed at insulating its European earnings from sharp currency swings.

"Our major cost elements, energy and hydrocarbons in particular, are dollar-denominated, and our total operating costs are on an increasing trend," Mr. Kaufmann said in a statement. He said Dow was initiating the mark-based pricing structure "to avoid an erosion of our margins."

Mr. Kaufmann said Dow Europe, excluding consumer specialty products, posted a narrow operating loss in the second quarter-its first in a decade-and has been trying to push prices up. "The currency turmoil complicated this plan," he said.

Dow reported a 20% decline in second-quarter net income to USD 186 million, or 68 cents a share, from USD 233 million, or 86 cents a share, a year earlier. Last year, Europe accounted for 31%, or USD 5.88 billion, of Dow's USD 18.81 billion in sales.

Du Pont Unlikely to Follow

Leading Dow competitors said they weren't inclined to

line up behind the mark. Du Pont Co., Wilmington, Del., "doesn't have any plans at present" to change from doing business in local currencies, said a Du Pont Europe spokesman. Germany's BASF AG and Belgium's Solvay & Cie. said their currency hedging strategies provided adequate protection against unstable currency markets.

In Italy, ECP EniChem Polimeri, the polyethylene subsidiary of Italy's ENI state energy group, said it will make selective price increases on various products. EniChem said it bases its prices on local currencies and doesn't plan to follow Dow in a mark-based price structure. On the other hand, a spokesman for Montedison S.A. in Italy said the company's Himont polypropylene subsidiary has based its prices on marks for years to avoid risks from currency fluctuations.

Nor were companies from other industries adopting a Euromark strategy. International Business Machines Corp., Armonk, N.Y., is organized in Europe on a country-by-country basis, and transacts business and pays taxes in those currencies. "It would be an additional currency risk for us to bill in marks," said Joerg Winkelmann, an IBM Europe spokesman.

Honeywell's Method

Honeywell Inc., Minneapolis, said the industrial controls company conducts business among its European units in European Currency Units, or ECUs, and with its U.S. parent in dollars. In negotiating contracts with customers, Honeywell said, its local subsidiaries often obtain currency-index provisions to protect against sharp swings.

In the steel industry, Luxembourg's giant Arbed S.A. said it is concerned about the currency turmoil. But, said Albert Rinnen, a finance executive, "we can't impose on our clients to be paid in Deutsche marks, Belgian francs or pesetas. It's not that easy to sell steel in this kind of climate."

A spokesman for the Netherlands' NV Phillips Electronics says the company is more worried about high interest rates than fluctuating currencies. If the instability were to persist, however, the Dutch electronics giant says it might need to make some "strategic changes" in its pricing policy. But it declined to elaborate.

Unilever, the Anglo-Dutch consumer products giant, says it has been little affected by the currency upheavals. "We produce consumer goods in 87 countries. Our individual local companies mainly produce for their own market," a spokesman said. If anything, he added, the weakness of the dollar helps because it tends to reduce raw materials costs.

Some companies are downright sanguine about the vicissitudes of the past two weeks. "We are extremely relaxed" about the current situation, says a spokesman for Paris-based L'Oreal S.A., the giant cosmetics company. "We aren't at all worried. We've dealt with this kind of problem for 85 years. We've seen even more brutal fluctuations in the past."

Source: *The Wall Street Journal* (28 September 1992)

Questions

1. Why might Dow Chemical benefit from pricing all

of its European products in German marks?

2. Dow Chemical's strategy (of pricing all of its European products in German marks) was announced shortly after the exchange rate mechanism (ERM) was adjusted to allow much wider bands around the exchange rates between European currencies. Explain why the ERM adjustment may have caused Dow Chemical to implement the strategy.

3. Why might Dow Chemical's cash flows be adversely affected by its strategy of pricing European products in marks?