Leads and Lags: Definition, Example, Risks

What Are Leads and Lags?

Leads and lags in international business usually refer to the deliberate acceleration or delaying of payments due in a foreign currency in order to take advantage of an expected change in currency exchange rates.

Corporations may time payments due in a foreign currency if they anticipate a change in currency values that is in their favor.

Key Takeaways

- Leads and lags refer to the timing of payments (delaying or advancing) on international business agreements to take advantage of a more favorable or anticipated exchange rate changes.
- Not all currency-rate events can be forecast, but those that can are often tied to political or financial events.

Understanding Leads and Lags

A corporation can control the schedule of payments received or made, within reasonable limits. When a payment to a foreign entity is involved, the organization may opt to pay earlier or later than scheduled. These changes would be made in anticipation of capturing the benefit from a change in currency exchange rates.

This consideration can affect the smallest or the largest transactions. If a company in one country were about to acquire a company in another country, and the target company's country currency was expected to decrease in value relative to the acquiring company's country, delaying the purchase would be in the interest of the acquiring company.

A strengthening of the currency being paid out would lead to a smaller payout for the entity in question, while a weakening of the currency would lead to increased costs the longer the payment was delayed.

Risks of Leading and Lagging

Because it amounts to a timing strategy, leading and lagging implies risks. Currency rates can move in an unexpected direction.

When a business has an expected foreign exchange transaction, it may need to buy or sell the currency that it needs to complete the transaction. Currency prices move in response to supply and demand between Forex traders, companies, and nations.

Examples of Timing a Foreign Payment

Currency exchange rates are difficult to forecast, but certain financial and political events may play out according to a predictable schedule. These predicable scheduled events can provide insight into the direction of a exchange rate. Such events can include elections and budget deadlines.

For example, Great Britain's decision to exit the European Union, known as Brexit, was triggered by a referendum on June 23, 2016. The British pound fell in value versus the U.S. dollar immediately after the vote. It kept falling for some weeks afterward before recovering slightly. As of May 25, 2022, it still has not recovered to its pre-Brexit levels.1

If a U.S. company has agreed to buy a Canadian asset it will need to buy Canadian dollars and sell U.S. dollars to complete the transaction. The Canadian dollar moves constantly in its value compared to the U.S. dollar. In the year ending May 25, 2022, for example, the Canadian currency ranged between about $1.20 and about $1.30 in comparison to the U.S. dollar.

If the company believes the Canadian dollar is going to strengthen against the U.S. dollar. it will accelerate the transaction (lead) before the price of the asset increases in U.S. dollar terms. If the company believes the Canadian dollar will weaken, it will hold off payment (lag) in the hope that the bill becomes cheaper in U.S. dollar terms.

What if the company guesses wrong? If, for example, the Bank of Canada unexpectedly raises interest rates the Canadian dollar will strengthen. That will make the company's decision to hold off paying detrimental. Some companies hedge their bets by making part of the payment at the time of the agreement and waiting to pay the remainder