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Foreign Exchange Management: New Opportunities and a New Perspective

by Professor Christine R. Hekman, The Peter F. Drucker Graduate Management Center, The Claremont Graduate School

Foreign exchange exposure management has traditionally been viewed by corporate line management as a specialized and arcane corporate function. From its organizational position in Treasury or International Treasury, the function and the experts responsible for its execution, are frequently removed from the process of strategic planning and formulation of objectives. Foreign exchange experts are even less frequently consulted on matters of marketing and production investments and operation.

This paper will demonstrate that companies which operate in global markets and seek to gain or retain competitive advantage jeopardize those objectives when they overlook the organization's foreign exchange expertise. Conversely, consider the line management functions from the perspective of the global marketplace and the potential role of foreign exchange managers as internal consultants is obvious.

This paper adopts that global perspective and considers the management objectives assigned to each line management function. The paper considers, in a global context, the fundamental issues which confront each function and demonstrates the relevance of foreign exchange rates to these issues and challenges. Finally, the paper identifies those simple but powerful fundamentals of foreign exchange rate management which are most relevant and applicable to functional line management decisions.

In sum, the paper argues that, in the perception of line managers and senior executives, foreign exchange management expertise must migrate from its isolation within the Treasury function into the role of internal consultant to management. Only with this move, will management acquire sufficient expertise to manage the increasingly important currency component of today's global business decisions.

A Traditional Perspective on Foreign Exchange

Since the early 1970s, when foreign exchange rates first began to fluctuate significantly, corporate management has sought to explain, predict and manage the effects of exchange rate changes on corporate financial reporting. Initially, the Financial Accounting Standards Board in the United States, and corresponding bodies elsewhere, have struggled with revisions of the translation mandates in attempts to make the reported effects of exchange rates changes more 'realistic'.

With this activity as a background, responsibility for the organizational response to changes in foreign rates was centered in the corporate treasury, accounting, and control functions. For most companies in the 1970s and early 1980s, the consequent emphasis on strict quantification resulted in a corporate preoccupation with reported earnings rather than with more economic and strategic measures of managerial effectiveness.

Late in the 1970s, however, several economists began to look beyond nominal exchange rates to consider the entire global pricing system within which exchange rates are determined. These developments fed other academics and sophisticated corporate managers who were attempting to measure and manage the effects of exchange rates not only on reported earnings, but also on corporate value. The concern with exchange rates and corporate value was also consistent with a growing realization that investment, pricing, sourcing and funding decisions are the precursors of financial hedging in the corporate risk management arsenal.

With the development of this understanding and perspective in most academic circles and many corporate executive offices, the stage has been set for a more direct channel of communication and support between line management functions and decisions and the foreign exchange experts.

A New Perspective on the Role of Foreign Exchange Management

The newest developments in foreign exchange management have been stimulated not by the treasury, accounting, and control functions, but the line managers themselves. Investment, pricing, and sourcing decisions, and the effectiveness with which these decisions are executed, have become increasingly dependent of foreign exchange rates as markets become more global in scope. The foreign exchange rate is correctly seen by these managers as the most important of all market prices.

The foreign exchange rate is the relative price of the monies with which national business units operate in local markets. Only through this 'window' can the globally effective company interpret and compare prices and costs in local markets. In consequence, the expertise which is resident in the foreign exchange management function is increasingly valued as an input to these basic business and strategic decisions.
With a new perspective on foreign exchange management, experts in foreign exchange work as internal consultants to line managers on important business decisions. Their role is to identify the 'currency component' of those decisions, to catalogue various currency management techniques, and to more clearly define the currency costs of strategic and operating proposals.

Currency Component Analysis for Marketing Management, Operations Management, and Management of Human Resources and Organizational Planning

To evaluate the impact of currency component analysis on traditional management functions, we must first define and separate those specialities. In practice, the characterization of management functions depends on each firm's particular organization. For illustrative purposes, however, we capture the essence of the approach by considering three areas of functional responsibility. Marketing management is assumed to focus primarily on the customers and competition. Operations management focuses on sourcing and production techniques. Human resource managers consider the structure of the organization and manage employee training, and performance incentives. For companies in global markets, information and analysis from the foreign exchange markets is essential input to the groups' most basic decisions.

The nature of functional specialties implies that each group manage to particular measures of effective performance. In an environment where the market and sourcing opportunities and effective or potential competitors are strictly local, these ratios depend on the interaction of local prices and costs and functional performance. In global markets, however, performance ratios will be affected, sometimes substantially, by changes in foreign exchange rates - the currency component of global prices. In these business situations, input from the foreign exchange management function provides crucially important information and analysis.

The Marketing Function and Foreign Exchange Rates

Marketing management's central objective is to increase market share. Though other variables may affect marketing decisions, the primary measure of marketing effectiveness is found in competitive performance in the market.

The marketing function looks to the firm's operations to provide product and has responsibility for ordering product from operations divisions. Marketing also has customer responsibility - marketing, selling, delivering, and servicing the product. Discharging these responsibilities requires study of both the customer and the competition. Decisions include determining which markets to enter, recommending modifications to product design, and setting a price. A decision to enter a particular market reflects an assessment that market potential exceeds the costs of market entry. The latter may include investment in a distribution system, costs for development of brand awareness, etc.

Within a competitive environment, marketing management must consider not only the customer and the costs of production and market entry, but also the competition. In a sense, the firm's costs of meeting market demand must be compared to the costs incurred by actual or potential competitors to meet the same demand.

Management which develops and supplies a market more effectively than the competition is rewarded with the evidence of success - greater market share.

In markets which are effectively insulated from the global environment, foreign exchange rates have no effect on market share and relative competitive performance. Without such local insulation, however, any number of important components of the business product - production inputs, research talent, financial capital, capital equipment - may come from abroad or be produced by firms with foreign owners. Even without these direct connections to local markets, most firms confront either foreign competition, or local competition which has become adept at sourcing abroad. In the presence of any of these global factors, market share is no longer independent of foreign exchange rates.

Changes in foreign exchange rates are likely to change the effective prices paid for production inputs by the firm and its competitors. With foreign capital in the picture, either as ownership of the competition or of the firm at hand, foreign exchange rate levels determine the willingness of companies in the industry to compete for market share by temporarily sacrificing return to capital. Finally, exchange rate changes usually change the effective or all-in price of the product in each of the subject company's foreign markets.

The key point is that marketing management's scorecard is often significantly influenced by foreign exchange rate levels and by changes in foreign exchange rates. Meeting market share targets in a global environment requires an analysis of the effects of foreign exchange rates on corporate costs, sourcing opportunities, and profit motives. It also requires that marketing management assess the impact of exchange rates on competitors.

The Production/Operations Function and Foreign Exchange Rates

Operations management evaluates its actual and prospective performance relative to a number of key measures. The most central of these is the operating margin. Operating divisions which consistently beat the competition's proportional margin are at the core of any successful manufacturing business.

Success at maintaining a competitive operating margin derives from the solution of a basic dilemma - minimize
costs while maximizing flexibility. A marketing strategy which calls for greater product customization demands operating flexibility. This implies shorter production runs, more frequent machine changes, and usually, more human intervention. Unfortunately, flexibility is usually bought at the expense of operating efficiency.

The explosion of global market opportunities and global competition has heightened this dilemma. On one hand, development of foreign market share often calls for products tailored to the needs of particular and distinctive cultures and geographies. On the other hand, effective foreign competition challenges a company's ability to charge a premium or even adequate price for these modifications from the standard, cost-effective alternative.

As markets become global, most firms are pressed to simultaneously improve operating flexibility and cost efficiency. The tension imposed on operations by this dilemma, and management's success in finding solutions, show up most directly in the operating margins.

Two related strategies potentially ease the tension by reducing costs. The first is foreign sourcing. The second is relocation of production abroad. (Foreign production is actually a variant of foreign sourcing since its primary advantage is access to a low-cost foreign labor pool). These strategies are complemented by a strategy of sourcing flexibility - operations and sourcing locations can be shifted in response to shifting cost advantage.

Foreign exchange rates, in both level and variability, have enormous effects on both the costs and returns to product differentiation. We have already considered the effects of exchange rates on market share at home and abroad. Operations managers confronting global markets are being forced to recognize the direct and indirect effects of foreign exchange rates on operating margins.

Foreign exchange rates have a direct effect on sourcing and location and production process decisions; exchange rate levels and local price levels combine to determine relative costs of location, sourcing, etc. In this context, exchange rate analysis is a crucial input into investment and operating decisions.

Exchange rates also influence operations through their variability. Low-cost center of supply or production materialize or disappear as local currency exchange rates rise and fall. The implication is that operating management may choose to shift production location or sources of supply in response to shifting rates. At a minimum, they are forced to decide whether changes in relative cost alternatives reflect fundamental changes in industry conditions or more generally reflect changes in monetary and currency conditions.

**Human Resource Management, Organizational Structure and Foreign Exchange Rates**

If we can identify any single measure of the effectiveness of human resource management and organizational structure, it is the deviation of actual from budgeted performance. If the budget process is sound and consistent with objectives, personnel is adequately trained and supported, and the organizational structure is appropriate to both objectives and environment, the group's performance should consistently exceed budget.

The influence of foreign exchange rates on the human resource function are both more and less direct than the influence of rates on the other management functions. The direct and significant influence comes through the impact of exchange rates on actual performance and deviation from budget. Conversely, exchange rates influence organizational structure and design indirectly through their effects on key marketing and operations decisions. Consultation with foreign exchange specialists can be extraordinarily useful as human resource managers adjust the organization's structure and programs for incentive and compensation.

In a general sense, the human resource management function is integrally related to the marketing and operations management teams. Marketing looks to the customer and competition; operations looks to the suppliers. Human resource managers promote the achievement of appropriate and effective responses to customers and suppliers of facilitating the coordination of the marketing and operations initiatives. Marketing and operations are separately responsible for the specifics of a given response which relate to their responsibilities. HRM insures that the combined initiative reflects an appropriate balance between sometimes contradictory functional perspectives.

The most effective functional coordination is achieved without active intervention into marketing and operations decision processes or outcomes. Instead, HRM works passively through management of structure. Coordination is achieved through the appropriate design of the organizational structure and through design and management of the performance evaluation system which hold the structure in place.

When the HRM function is charged by circumstance with promoting a coordinated response to global markets, HRM managers find themselves confronting important questions about the effect of exchange rates on both corporate organizational structure and performance. What effects do foreign exchange rates have on the relationships between operating divisions? How do changes in foreign exchange rates affect group and individual performance? Are the measured effects on performance 'real' or artifact? Should individuals and groups be held responsible for the effects of changes in exchange rates or should they be re-
lieved of that responsibility? If relieved, who should bear the responsibility?

These concerns are effectively summarized within HRM's objective - to minimize instances where performance is under-budget. HRM's achieve this objective through design and management of both the budget itself and the system which measures and rewards performance. Performance is also affected through design of the organizational groups and relationships which comprise the company.

The central dilemma in the design of any performance evaluation system is exacerbated by foreign exchange rates. The key to effective and constructive performance evaluation - evaluation that empowers and rewards rather than demoralizes individuals - is the merger of accountability and control. Individuals should be held accountable for results they can affect, but not for circumstances or events which they can neither foresee nor manage.

Foreign exchange rates, driven as they are by aggregate, monetary factors, are beyond any manager's influence. When exchange rates or changes in rates cause bias in performance results and the responsible managers are unable to respond, the performance evaluation must be adjusted accordingly.

The challenge, from an HRM perspective, is to distinguish exchange rate effects which are manageable from those which are not. Foreign exchange specialist can provide a simple framework of analysis for this problem. Further, the framework they provide is both simple and sufficiently flexible as to account for differing economic and competitive situations.

When this framework is factored effectively into a comprehensive budgeting and evaluation system, the organization's performance will meet or exceed target, stated in the home currency, more consistently. In essence, the strategic objectives and the market environment demand appropriate and effective response to foreign exchange rates and rate changes, exchange rates must be central to measurement of performance.

The second HRM responsibility, design and management of the organizational structure, is also dramatically, though indirectly, affected by foreign exchange rates. Since exchange rates are the interface between suppliers and customers in different nations, their levels and stability are central to the basic organizational dilemma - centralization or decentralization?

As we have seen in the preceding sections, pressure for market share growth in a global environment drives marketing managers toward greater differentiation of product. The same pressures of globalization together with pressure for margin improvement, leads operating managers toward dispersion of production location and sourcing relationships. The HRM challenge is to determine whether coordination is more effectively established through centralization or decentralization of the organization. When this dilemma is solved most effectively, the HRM objective-minimizing instances of below budget performance - will be accomplished most reliably.

In essence, foreign exchange experts can provide a perspective on global markets and a framework for comparison to local or traditional markets which informs the human resource management function's assessment of the need for organizational flexibility and the competitive implications of a choice for a centralized versus decentralized organization.

**Foreign Exchange Managers as Internal Consultants to Marketing, Operations, and Human Resource Management**

As global market opportunities and challenges become more prevalent, line managers must turn with increasing regularity to experts in foreign exchange for understanding of the global price and exchange rate system. In the preceding sections, I summarized the objectives of each function - marketing, production, and human resource management. I also showed how the levels of behavior of foreign exchange rates can significantly affect the achievement of objectives. These functions, objectives, and central issues are summarized below:

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<th>Functional Responsibility</th>
<th>Objective</th>
<th>Central Issue(s)</th>
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<tbody>
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<td>Marketing Management</td>
<td>Growth in market share</td>
<td>Cost of Market entry vs return</td>
</tr>
<tr>
<td>Production Management</td>
<td>Increase operating margin</td>
<td>Flexibility vs cost efficiency</td>
</tr>
<tr>
<td>Human Resource Management</td>
<td>Minimize under-budget Management performance</td>
<td>Control and accountability</td>
</tr>
</tbody>
</table>

When foreign exchange managers act as internal consultants, they support functional managers' in their attempts to adjust both the substance and process of their decision-making to recognize and account for exchange rates, prices, and costs in the global environment. For marketing, these adjustments require assessment of the effects of foreign exchange rates on the costs of market entry and maintenance of market position as well as the potential return from continuing commitments to foreign markets. Operations managers must incorporate exchange rates in the calculations which weigh the costs of flexible manufacturing alternatives against the gains to high-volume, standardized processes. Human resource managers
must adjust budgets and measures of performance to recognize both predicted and effective, actual exchange rate changes. They must also consider the effects of exchange rates in a geo-monetary process which pulls operations and marketing between local and global environments.

In a more concrete sense, there are a number of specific management evaluation activities where internal foreign exchange consulting is particularly valuable. The first of these is variance analysis. The currency element is important whether the variance to be analyzed is between target and actual market share, predicted and actual costs or productivity, or deviation of operating margin from plan. In fact, currency component analyses of deviations from plan often provide leading indicators of change in the structure of competitive markets or sourcing networks.

The currency component is an often critical aspect of pricing or transfer pricing decisions. These decisions can lead to success or failure especially when foreign competition or a global sourcing network are important elements of strategy.

Finally, a study of the currency components of corporate decisions can lead to real understanding of the nature of the markets in which the firm operates. Are these markets essentially global or local? What are the implications of this distinction for competitive viability? And this background of understanding is, in turn, basic to any organizational decision regarding centralization or decentralization of activities.

In a more strategic sense, internal foreign exchange consulting has some important, indirect effects. As the consulting relationships develop and line managers become more comfortable with currency considerations, they develop significant understanding of the relationships between corporate objectives and exchange rates. In addition, as these managers come to understand the linkages between local prices, global prices, and exchange rates, they achieve new insights on the basic nature of the corporation's competitive advantage.

Lessons for Functional Management from Foreign Exchange Experts

There are two concepts which are so fundamental as to seem trivial to foreign exchange managers, but which functional managers will find enormously useful. The first is the distinction between nominal exchange rate changes and changes in effective costs. The second is the use of the forward foreign exchange rate or interest rate differential for distinguishing between short run and long run swings in the market.

Nominal exchange rate changes represent the superficial effect - translation of costs and prices between currencies. These are related to, but different from the changes in effective costs and which may be stimulated by the exchange rate change. Line managers may be prompted to consider the joint determinants of effective costs and prices - exchange rates and local costs and prices. In this context, exchange rate fluctuations are seen either as changing effective costs or market returns, or as changing the relative attractiveness of different suppliers and markets.

The forward market can be described to line managers as a vehicle for distinguishing between deviations of the exchange rate from a fundamental trend and changes in the underlying fundamentals themselves. Foreign exchange consultants can effectively promote the use of forward market rates in projections as well as for input to longer run strategic planning.

Conclusion

This paper has considered the use rather than the substance of techniques of foreign exchange management. In my discussion of opportunities to use foreign exchange expertise in more direct cooperation with line management decisions, I developed the term 'currency component'. The message is that effective management in today's markets requires recognition and treatment of the currency component of basic operating, marketing, and organizational decisions.

This recognition and analysis is best accomplished through the cooperation of line and foreign exchange managers. Foreign exchange has been formerly perceived as specialized staff support for the Treasury and financial functions; cooperative global market analysis requires that line managers in the basic functional disciplines gain access to this support. It remains to be seen whether these relationships will be initiated primarily by foreign exchange experts themselves or by the line managers who so desperately require access to their expertise.