Reserve Bank of India Occasional Papers
Vol. 21, No. 1, Summer, 2000

"Exchange Rates and the Firm" ***by Richard Friberg, 1999, by Macmillan Press Ltd.,*** **Great Britain, and by St. Martin's Press, Inc., United States of America, Priced at 45 pounds, PPX + 174**

The impact of fluctuations in exchange rates on asset values and profits of firms has been engaging a great deal of interest in recent years in the economic and financial literature. Micro-economic underpinnings for this interest have been provided by multinational firms suffering declines in market shares and profits on account of changes in exchange rates. For the book entitled "Exchange Rates and the Firm" by Richard Friberg, the intellectual impetus stems from recent changes in the international environment such as the formation of Economic and Monetary Union (EMU) in Europe and the currency crises in East Asia which have brought about a fundamental revision in various strands of economic enquiry, including the theory of the firm. Exchange rate risk is part of wider macroeconomic risks, especially those relating to domestic interest rates, inflation rates and political developments. In fact, as the book points out, the recent exchange rate crises were not independent events. They showed that exchange rates, are an important channel for the transmission of policy and other shocks affecting the firms.

A recurring theme in the book is 'Economic Exposure'. Whether and to what extent a firm is adversely affected by a given change in exchange rate, depends not only on the change in question, but also on how the competing firms and consumers react to the resulting change in product prices. Individual firms ward off the adverse effects of exchange rate fluctuations on their asset values and net profits by taking recourse to instruments of hedging - forwards, futures, swaps, and options. Developments relating to the proliferation of these instruments and the evolution of markets for them have dominated the current literature on finance and markets. However, the treatment of this subject in the book, especially in Chapter 5 is disappointing, leaving much to be desired in terms of clarity, precision and detail, especially with

respect to the *modus operandi* of the instruments in question. In defence of the book, however, it needs to be recognised that, "if you use up resources in the process of hedging you will furthermore lower cash flows over time. Limiting variability will then be associated with lower returns." (pp. 23). There are also the practical problems involved in constantly updating the different instruments of hedging as well as in holding differing numbers of the various hedging instruments in the face of temporal shifts in underlying fundamentals and degrees of exchange rate risks. Indeed, there is an inherent imperfection in the very devices of hedging in so far as forward exchange rates and forecasts thereof are largely based on spot rates, so that using forward contracts to hedge has the effect of locking oneself into the spot rate. Even in the best of circumstances, the various instruments of hedging offer only partial protection against negative effects of exchange rate variation; they merely help to buy time during which real operations, particularly the selling prices of internationally traded goods, can be adjusted suitably.

The empirical findings by several studies cited extensively in the book are mixed and do not establish conclusively that there is any significant influence emanating from exchange rate movements on sales or profits of firms in various countries. One study, concerning 156 Canadian firms, reports even perverse effects. In their cross-country study, Griffin and Stulz (1999) virtually dismiss the 'economic relevance' of exchange-rate movements, and instead find 'industry-wide shocks' to be more important in explaining financial fortunes of firms. However, these negative empirical results do not appear to deter the author from proceeding with very elaborate discussion of the principle theme of his book. 'Diversification' (which involves setting up production facilities and marketing networks in several countries) and 'flexibility' (which involves ability to shift rapidly production and/or sales from one country to another in the face of exchange rate variations) constitute the two basic elements of strategies adopted by firms to deal with exchange rate exposure. Two specific cases could be of special interest to the reader: the collapse of Mexican peso in 1994 and the South Korean currency crisis in 1998. Exchange rate

fluctuations entail transnational extensions of production facilities. The author mentions several cases of firms in countries like Germany, Japan, U.K. and Canada setting up their production facilities in the US during periods of a strong dollar. Are we then to deduce that exchange rate fluctuations serve as a blessing in disguise by promoting international mobility of capital and enterprise? Such a deduction seems at least permissible (if not inescapable) in the light of what emerges from the author's discussion of the strategies of 'diversification' and 'flexibility' on the part of firms so as to insulate themselves from exchange rate repercussions.

It is also important to underscore the widespread prevalence and exercise of 'market power' on the part of sellers of internationally traded goods. A firm with market power generally tends to pass very little of exchange rate increase onto the consumers, since the firm would already be charging the maximum price before the exchange rate increase. The author refers to specific strategies on the part of business to acquire and maintain 'price-setting power' in the interesting case of the German Auto giant, Volkswagen, which had originally achieved market prominence by concentrating on low priced cars and was eventually forced to target higher priced segment by competing on quality and style rather than on price.

The book has interesting discussions regarding the formation of Economic and Monetary Union (EMU) in Europe, "the largest institutional change to take place on the monetary scene for a very long time." (p.111). The discussion covers a wide spectrum of issues within EMU, pertaining to institutional arrangements, price level, exchange rate, financial market, pattern of industrial and commercial competition, structure and management of banking, and above all, stance and conduct of monetary policy within EMU, besides implications of all these for non-EMU countries.

The book expects EMU to change significantly exchange rate exposure of all EMU firms, as well as of all those non-EMU firms which are exposed to EMU areas through trade and/or

payments. The author apparently overlooks the crucial fact that the same factors (such as the dissimilar behaviour of exports, imports and of other sources of supply of and demand for foreign exchange), which gave rise to mutually offsetting movements in the exchange rates of the national currencies, would now ensure relatively greater stability of Euro. The different national parameters would now be subsumed under the overall macroeconomic parameters of the EMU area. This has implications for the possible nature and impact of the common monetary policy within EMU. The concept of 'optimum currency areas', first enunciated by Robert Mundell in 1961, assumes significance. The EMU is poorly equipped in this respect, as labour mobility is very low even within individual countries, while fiscal transfers at the EMU wide level are very small. Underscoring the difficulties and limitations that may present themselves in the way of ECB's (European Central Bank) implementation of a common monetary policy for the entire EMU area, the author lays great stress on the importance of the personalities who constitute the Central Bank board. Quoting Friedman and Schwartz (1963) the book makes the point that during the Great Depression in USA, lack of agreement among the twelve regional Governors of the Federal Reserve System led to policy blunders, thereby prolonging the Depression (pp. 148-9).

While most of the author's analyses and observations with regard to monetary policy in the context of the EMU deserve full approbation, a thoughtful student of international economics may not be inclined to go along with the author entirely. The proximate and immediate determinants of the exchange rate of any national currency are the behaviour of exports/imports, and the two-way flows of capital (both, direct and portfolio) and other financial payments/receipts, and such other sources of supply of and demand for foreign exchange. These, in turn, are very closely linked to technology, taste, the relative rate of economic growth at home and abroad, existence of tourism endowments, and the like. To club all these economic variables under monetary policy as under the EU, would obviously, to say the least, amount to a travesty of the very concept and connotation of monetary policy.

The book is valuable for its copious references, but in several other areas such as the monetary influences on the exchange rate, the prognosis regarding the EMU and the relevance of exchange rate exposure to the behaviour of firms nationally and trans-nationally, i.e. its very theme, it leaves the reader with a sense of *deja vu,* a feeling of much to be desired in this complex but highly topical area of financial markets and the firm.

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