This book deals with corporate risk management strategy with regard to macroeconomic factors, like exchange rates, interest rates and inflation rates. The book is explicitly divided into two parts. The first part focuses on the techniques used to estimate and manage macroeconomic risks, while the remaining chapters mainly relate to the managerial and strategic perspectives. The authors suggest that successfully designing and implementing a Macroeconomic Uncertainty Strategy (MUST) requires a comprehensive understanding of forecasting and hedging techniques.

The authors begin with the notion that exchange rates, interest rates and inflation are the three most important proxies for the firm’s macroeconomic risks. Managers should not be made responsible for the effects of macroeconomic shocks to firm performance, since these are beyond their control. Therefore, it may be in the interest of shareholders as well as managers to “filter out” such “noise” so as to have a better estimate of managerial efforts and ability. This argument is related to the agency problem and contract theory (Bolton and Dewatripont, 2005).

Chapters 3 to 6 are the “technical” part of the book. They present the readers with an excellent exposition along with real-world cases to see how the techniques work in practice. These chapters elaborate on techniques for estimating quantitatively the firm’s exposure to macroeconomic risk factors and for using financial hedging contracts to manage such exposures. Chapter 3 serves as recapitulation of international financial management basics (e.g., Mudambi, 1998). Chapters 4 and 5 present procedures for estimating exchange rate exposure and interest rate exposure using regression analysis. Chapter 6 focuses on techniques for hedging such exposures by various financial contracts.

Chapter 7 shifts to a checklist of the determinants of the level of hedging (“do nothing” to “variance minimization”), which include managerial perceptions of market behavior, risk-aversion and information requirements. Chapter 9 introduces the history of policy regarding the reporting of accounting information such as FASB 133, IAS 32 & 39, and how multinational corporations (MNCs) respond to such policies. There is evidence that MNCs place a great deal of importance on complying with national and international accounting regulations; the costs of compliance are low relative to the risks and costs associated with being penalized (Coates et al, 1993; Mudambi, 1999). One of the most critical risks associated with non-compliance relates to corporate reputation, an asset that is particularly important to MNCs (Fombrun, 1996).

The MUST (Macroeconomic Uncertainty Strategy) that the authors propose highlights several important issues. The first issue relates to the use of accounting-based measures of macroeconomic exposure. The authors argue such measures may be misleading with respect to the impact of such risks on long-term firm performance. They suggest that cashflow-based analysis is more appropriate because cashflow (or economic value added) also addresses the concerns of debtholders and other
stakeholders (such as employees). The second issue relates to effects of exchange rate risk. There is a popular misconception that such risk only affects foreign operations; however, since exchange rates affect relative prices, such risk impacts all of the MNC’s operations. The third issue relates to the firm’s transaction and translation exposure. It is sometimes argued in the popular press that such exposure only captures the accounting side of risk; however, since these exposures affect the MNC’s optimal resource allocation they affect the firm strategy as well. Overall, the authors suggest using cashflow-based measures and argue that the macroeconomic factor coefficients are more accurate estimates of exposures.

Macroeconomic theory suggests that international trade should eliminate arbitrage opportunities. This theory can be interpreted in several ways. The purchasing power parity (PPP) theory argues that differentials in inflation rates create arbitrage opportunities that will be eliminated by flexible exchange rates (Engel and Rogers, 2001). According to this view, inflation rate differentials should determine exchange rates. However, issues of tradability, transportation costs and central bank intervention can delay the transition to equilibrium in the international economy. Hence, while the PPP theory has strong intuitive appeal, it has been found to have limited explanatory power in the short run. On the other hand international Fisher parity (IFP) uses interest rate differentials rather than inflation rate differentials to determine exchange rates (Aliber, 1973). This theory tends to work better in terms of predicting short term exchange rates since international debt instruments (and bond prices) are more liquid and less restricted than trade in goods. Thus, a combination of the PPP and IFP theories is required to obtain a complete picture of exchange rate behavior.

The authors then explain the different impacts of macroeconomic factors and government-policy-related variables on MNC strategy. Macroeconomic factors (exchange rate, interest rate and inflation rate) are usually directly observable and they are directly involved in accounting decisions and short-term planning. Therefore financial hedging contracts are often written against these factors. On the other hand, policy variables such as monetary policy changes and government budget deficits may be the true underlying changes drive these macroeconomic factors. However, the relationship between policy variables and observable macroeconomic is generally very noisy.

Finally, the authors suggest discretion when applying regression estimates as the basis for decision-making. If the environmental changes are substantial, managers should focus more on the underlying reasons for such changes and act accordingly. This suggests shifting to different decision-making criteria, such as scenario analysis.

The authors successfully convey their ideas in non-technical language. The clear exposition enhances the value of the book, especially for students. For example, in chapter 5, they illustrate mathematical models with real-world cases. Chapter 9 actually has the firm disclosure practices in terms of macroeconomic risk management for a sample of multinational firms. It is very interesting to see the huge variance amongst firms in terms of their disclosure practices.

The cases and techniques in this book can be easily adopted in any international financial management course. Many of tables and figures that are used in the text serve to simplify complex procedures and guidelines. For instance, Tables 10.1 and 10.2 summarize the elements of MUST analysis and decision-making. Table 7.1 and 7.2 summarize the relationship between risk management decisions, managerial attitude towards risk and managerial views on market behavior. These excellent summaries are valuable teaching tools as well as guidelines for practitioners.

Overall, this book is a comprehensive checklist and handbook for managers and academics. As the authors touch a broad range of issues involved in risk management, it will appeal to a wide range of audiences. Students can use this book as resource on such materials as exchange rate exposure, options, forwards and futures, duration, PPP, IFP and so on. Teachers of international finance will find the detailed calculations within real-world cases easily adapted for use in class, e.g., the “profitability” in Volvo case in chapter 5. Researchers may find potential research interests, such as
managerial compensation, their adoption of MUST or the information disclosure with respect to firm risk management. Managers at all levels will benefit from this book as a reference and guide. MUST is a hybrid of complementary estimation and management techniques (traditional accounting-based vs. regression analysis and financial hedging vs. operational hedging) in contrast to the traditional view of risk management.

While this book is not exactly summer beach reading, it is a valuable resource for the shelf of any academic or practitioner. Some audiences may find a few of the chapters repetitive and the sequence could be streamlined. For instance, the qualitative content on determinants of decision-making, firm strategy and financial vs. operational hedging could be put together as adjacent chapters. In addition, since the objective is to compare tradition accounting-based exposure management with a value-based approach, the authors could have split chapters 4, 5 and 6 and rearrange them so that the corresponding estimations of exposure and hedging are adjacent.

References


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