

How to Measure, Monitor and Manage Global Risks

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Global Risks - I

2004 was the best year for the world economy since 1988 growing at 3.8%. The main drivers were the U.S. (4.4%), China (9.5%) along with all of South East Asia doing well and with Latin America growing at 6%, the best since 1980. On the other hand, Euroland continued to grow slowly (1.8%) as well as Japan (2.6%) whose growth was all in the first half of the year followed by little or no growth in the second half. The general expectation is that the world economy will slow down in 2005 to around 3.5% led by some moderation in the United States. Moreover, most of the risks to growth seem to be on the downside with U.S. interest rates rising and oil prices in general and commodity prices remaining very high which could easily temper consumer spending.

Global Risks - II

One of the biggest risks to the world economic outlook is a sharp fall in the dollar. The U.S. is running a balance of payments deficit of \$800 billion in 2005 which needs \$5 billion a day of inflows to be financed. There is little or no sign of any improvement in this deficit and the value of the dollar is dependent on China and South East Asia financing the bulk of the balance of payments shortfall. So far South East Asia had brought hundreds of millions of dollars but this could change quickly leading to a drop in the dollar and a further rise in U.S. interest rates. If this were to happen, the implications for emerging markets would be adverse.

Global Risks - III

Another key factor for the world economy is whether inflation will gradually pick up or whether we have entered a long period of low inflation. If this is the case then the good news is that interest rates will stay low but the bad news is that many (if not most) companies will find it very difficult to pass on increases in input prices. This is a very tough environment to do business and with the likelihood of many business failures.

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Apart from these macro-economic risks, there are plenty of financial risks facing the world economy. Credit spreads are very tight and could change rapidly alongside a tightening of liquidity. It is also important to be aware of the risk of sudden changes in capital flows. For example, enormous sums of money have poured into hedge funds in the last three years. Given very low (or negative) current returns this could easily reverse with serious consequences for stock market prices.

Global Risks - IV

Still, while all these risks are very important, the biggest and most continuous risk is for international company is that of currency fluctuations. As can be seen in the Appendices, currencies can rise and fall 40-50% on a regular basis. Unfortunately this is likely to remain a feature of the international scene so affecting all international players and poses a major challenge for corporate treasurers.



Measuring and Hedging Risks - I

Clearly there are plenty of global risks to worry corporate executives but not surprisingly I will concentrate on exchange risks. Of course, oil prices, business cycles, inflationary trends are all critical but for most international companies it is the cash flow, dividend flow and profit and loss statements which loom very large in the management of risks and where exchange rates can have a big impact. And, my first recommendation is to keep everything as simple as possible starting with determining the priorities which currencies to monitor. Here the obvious point is to start with these currencies that matter most to the cash flow/ bottom line etc whether that is the euro, the Mexican peso, the Polish Zloty or the Indonesian rupee. This can be done either by easy arithmetic or by using VAR models – the end result is usually the same.

Measuring and Hedging Risks - II

Apart from the fact that exchange rates vary substantially over a period of a few years, exchange rates are very hard to predict and on occasion go in the opposite direction of the consensus predictions (e.g. the Mexican peso and Brazilian real in the last year). Consequently, the starting point for a hedging strategy should be to define what is a “neutral” or a “passive” view on the exchange rate and from this determine what is a “neutral” hedge position. To me, neutral (or when it is unclear whether the exchange rate will rise or fall over the defined period) requires a 50% hedge. This means that whichever the direction of the future exchange rate movement, 50% of the exchange risk is covered whatever the company currency guru may have predicted.

Measuring and Hedging Risks - III

Of course, all of this may sound too simple or naïve but it works well. Also, given this base, when the view of the likely future behaviour of the currency is other than neutral, the degree of cover can rise to 75% or fall to 25% depending on the direction predicted for the exchange. In addition, given that forecasting becomes more difficult the further out the period covered, the recommended action is that the highest degree of cover is taken in the first quarter or two and then scaled down for longer periods. Then, as time elapses, the degree of cover increases to keep the near quarters well hedged. Importantly, I feel that it is unwise to immediately go to 25% or 50% or 75%, but hedges should be layered in.

Measuring and Hedging Risks - IV

Once having decided to hedge, the next issue is how to achieve the desired result (with cash flows or dividends at the target variable) and usually the choice comes down to the use of forwards or options. I have a bias to forwards if the hedged target is reasonably predictable. Forwards are usually cheaper than options and often by a considerable margin. Of course, options make sense when there is great uncertainty about the target variable or there is an outright position to be taken for whatever reason and, on occasion, a combination of forwards and options can offer an attractive hedging tool.

Measuring and Hedging Risks - V

Measuring the success or not of hedging has to be judged against the strategy adopted. It makes no sense to compare what would have happened if a 100% cover had been taken or a zero cover if the actual hedging base line was 50% cover. The correct measurement is to measure the success or failure against the base which means that if the actual cover was higher or lower than 50%, how does this compare with a straight forward 50% cover.

Monitoring

I am convinced that for any types of risks it is essential to monitor the risks on a continuous basis. The process cannot be ad hoc, for example quickly summoning a meeting after a particular event has taken place which in any case is usually too late. I feel that a Risk Committee should meet every four to six weeks to review the main areas of risk to the company. Thus, with most if not all of the likely risks reviewed with action taken, a quick response can be made if needed outside the regular meetings. I cannot stress enough that a formal process for regular meetings needs to be implemented as it is too easy to allow timetables to slip and so quickly revert to ad hoc monitoring which is dangerous. I would also suggest that at least every third meeting a special subject is reviewed in detail which adds to the range of risks covered and to the interest of the meeting.

Conclusion

When dealing with global risks, forecasting inevitably has to play a major role but it is best to keep forecasting down to minimum where ever possible. Thus, the 50% hedging rule for exchange rates means that cover is always in place regardless of any particular view of currency and that forecasting is restricted to the variance above or below 50%. And, never forget that economists do not have a crystal ball and they are almost invariably much better forecasting the past than forecasting the future!

Table 1: Global Inflation Is Expected to Remain Subdued in 2005

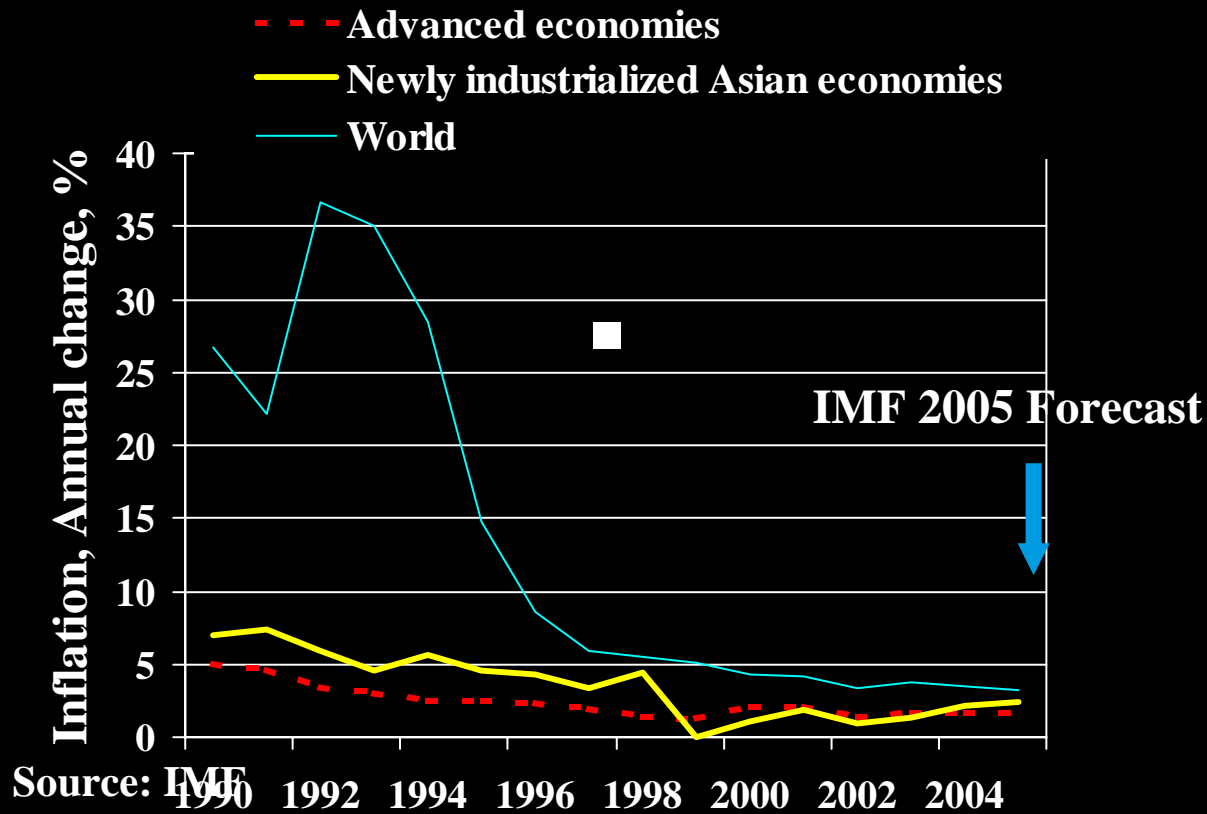
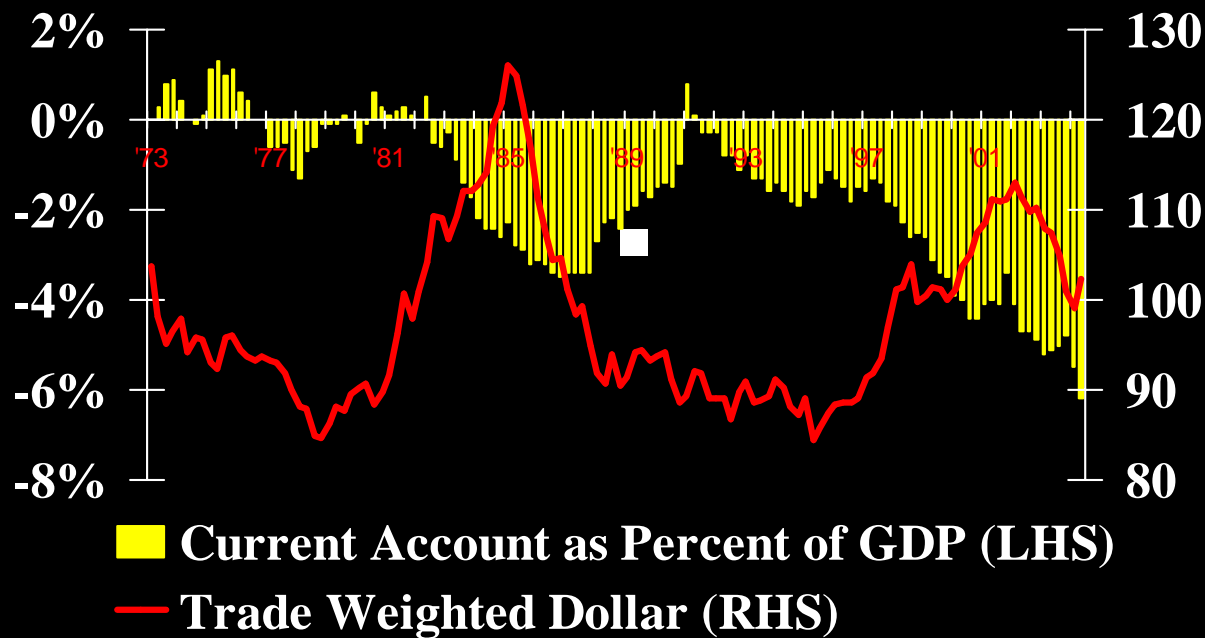


Table 2: U.S. Dollar and Exchange Rates

The Record Current Account Deficit Reflects a U.S. Savings Shortfall



Source: BEA, Federal Reserve

Table 3: Chinese Foreign Exchange Reserves Have Increased Sharply

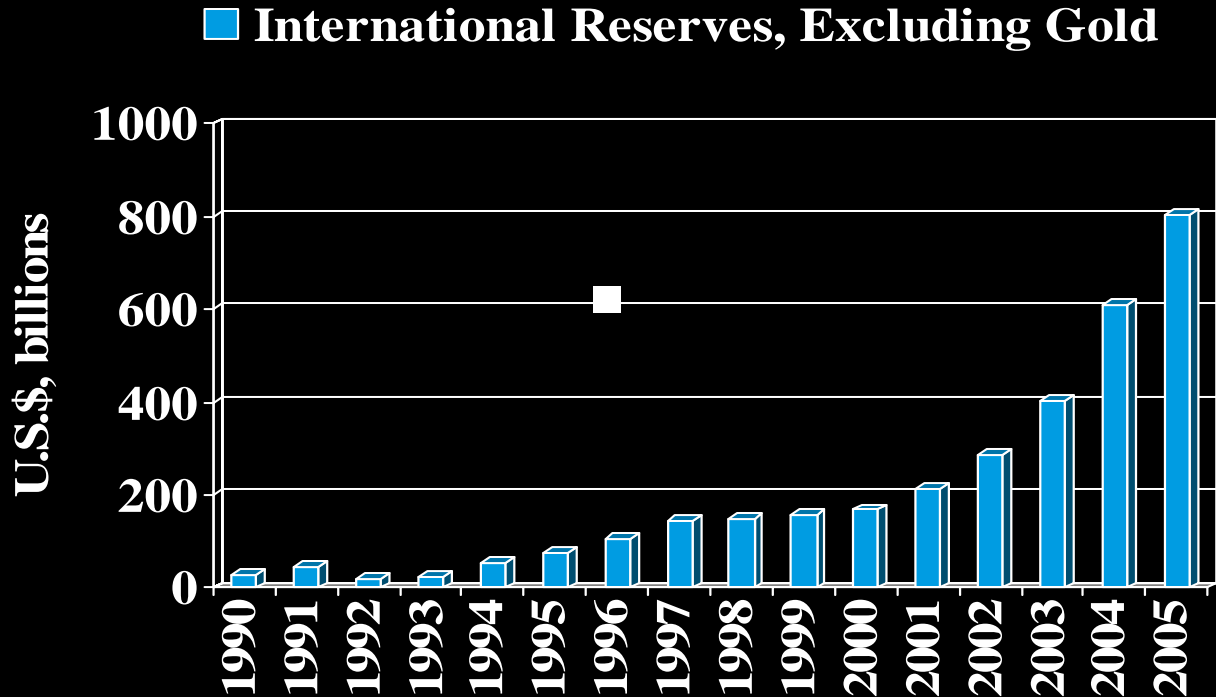


Table 4: In the Absence of Significant Price Pressures, Any Rise in US Interest Rates Will be **Gradual**

— 10 Year Treasury — Fed funds

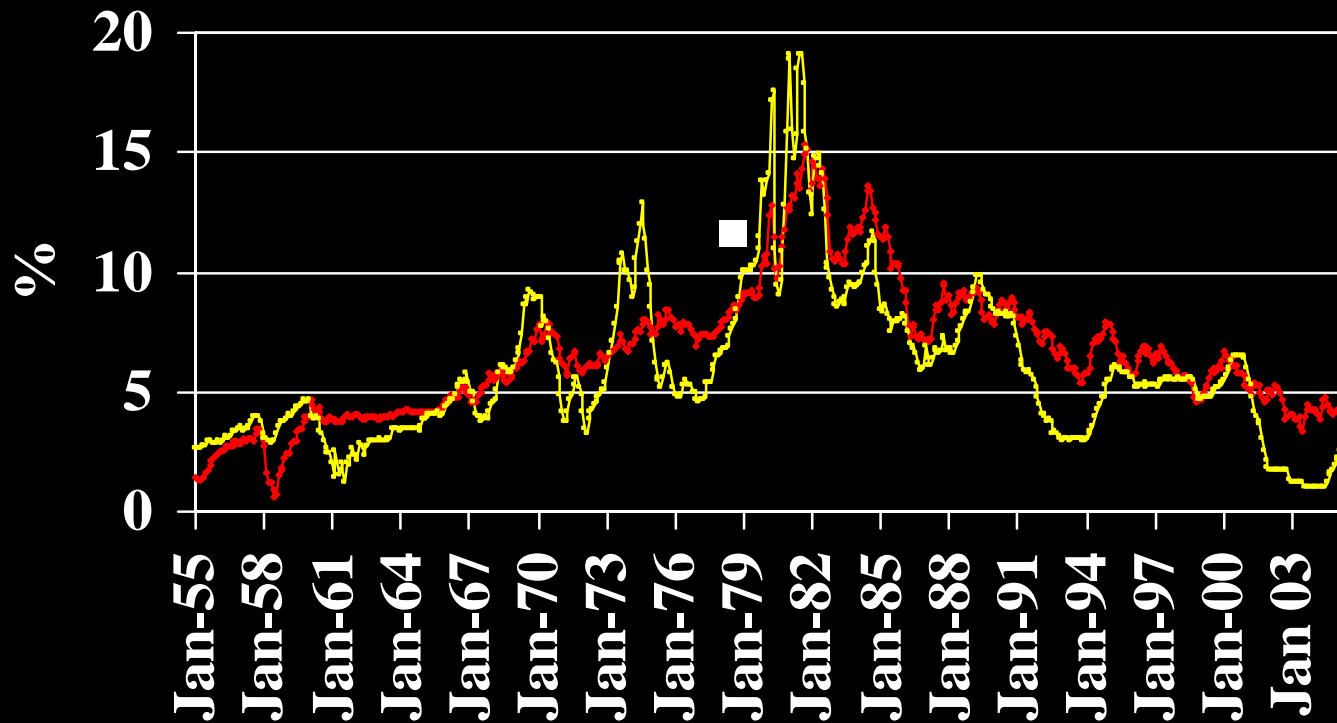


Table 5: Euro Spot Rate

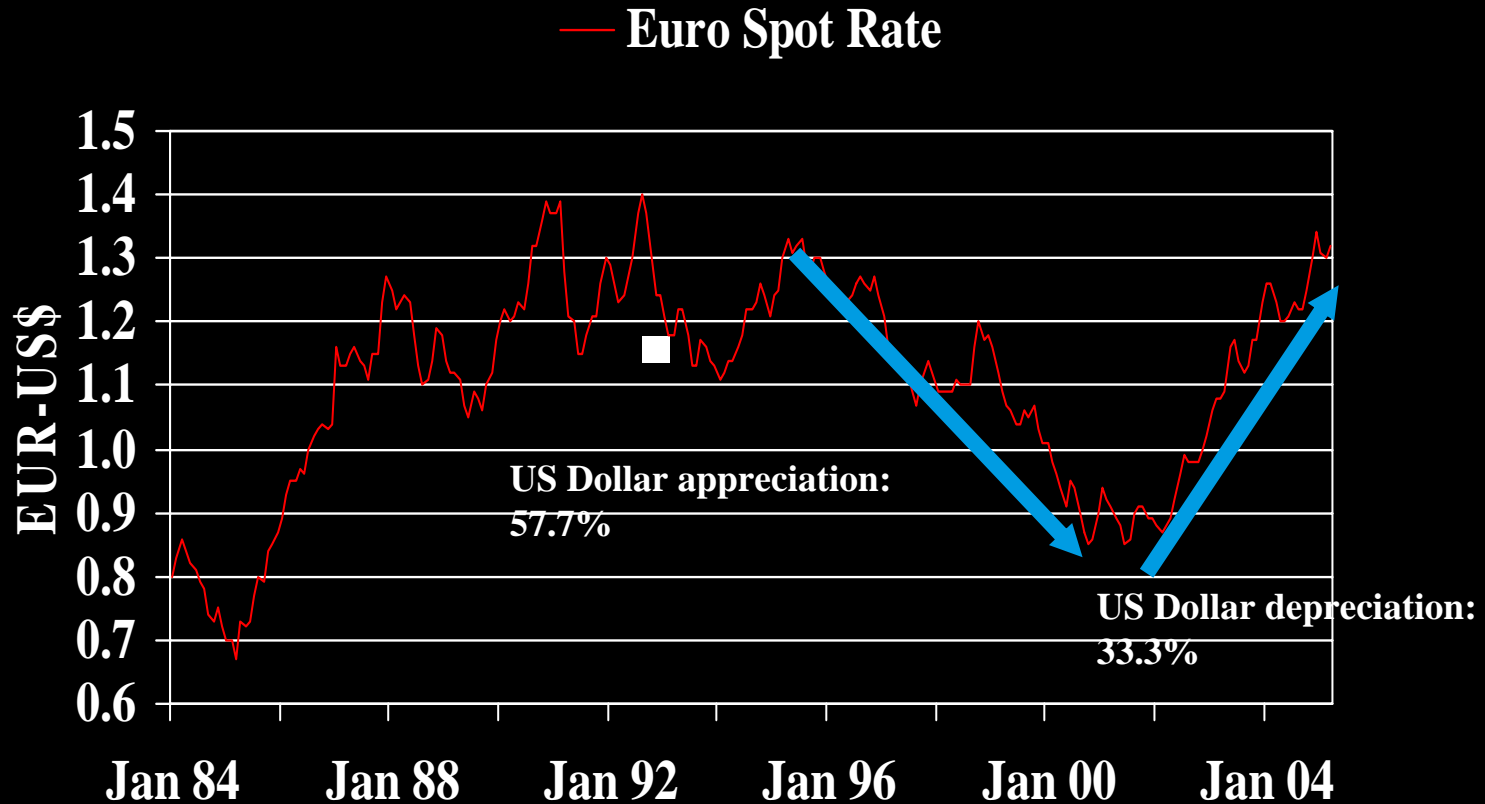


Table 6: Pound Sterling Spot Rate

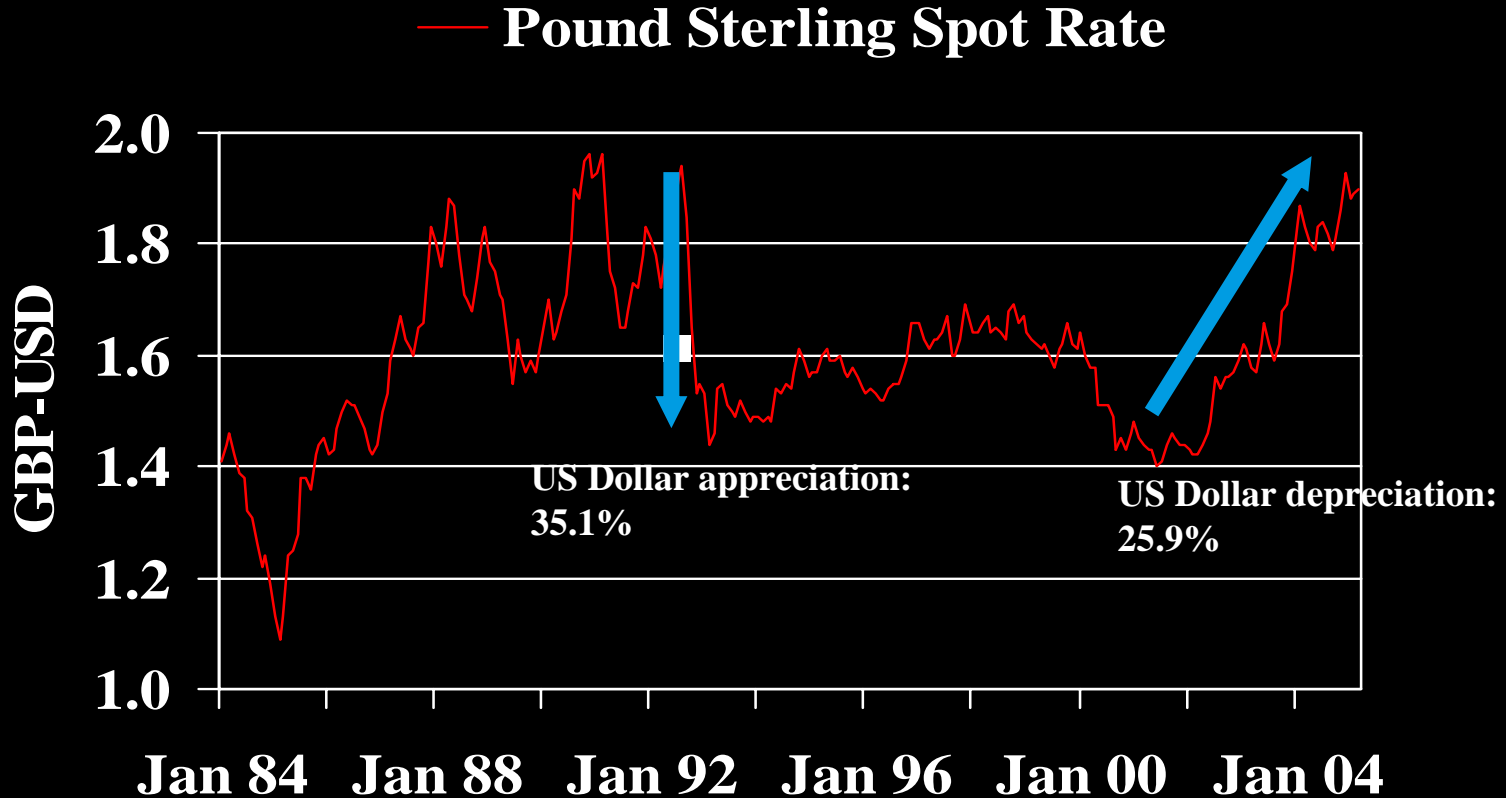


Table 7: Swiss Franc Spot Rate

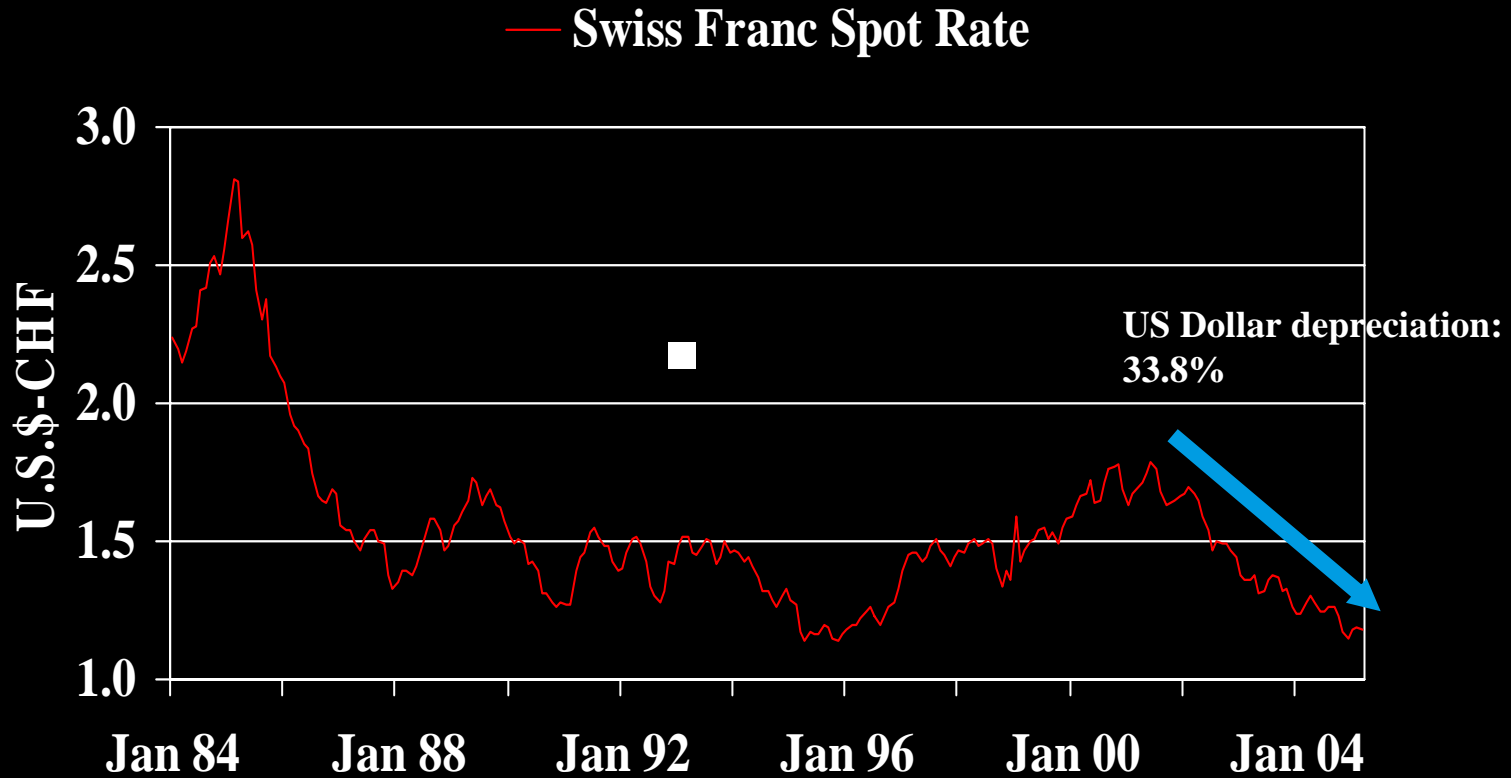


Table 8: Japanese Yen Spot Rate

