

**THE MANAGEMENT OF HIGH EXCHANGE RATE VOLATILITY
and CORE COMPETENCIES**

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Abstract

Recent events affecting many Asian economies demonstrate the potential turbulence to which national economies are subject in the present world economic environment. How do firms position themselves in a particular product market, industry, financial configuration etc., to respond to changing economic realities and simultaneously maintain the competencies required for long term success? Importantly while existing capabilities affect strategic decisions involving positioning within a firm's environment the reverse is equally true. A firm's positioning along a set of variable continua (such as exchange rate exposure) gives rise to its capability sets. Strategic decisions are framed in terms of current capabilities but then implicitly affect the trajectory of future strategic capabilities as well. Firms in emerging economies are at particular risk of turbulent environments eroding their core competencies.

Introduction

Recent events causing the collapse of the currency value of several Asian economies demonstrate the potential turbulence to which economies are subject in the present world economic environment. This is true particularly regarding the high degree of exchange rates volatility. How do firms position themselves in a particular product market, industry, financial configuration etc., to respond to changing economic realities and simultaneously maintain the competencies required for long term success?

This paper examines the impact of exchange rate turbulence on the maintenance of existing core competencies and the development of new ones. While capabilities affect strategic decisions involving positioning within a firm's environment the reverse is equally true.

A firm's positioning along a set of variable continua (such as exchange rate exposure) gives rise to its capability sets. Strategic decisions are framed in terms of current capabilities but implicitly affect the trajectory of future strategic capabilities such as the management of exchange rate volatility as well. In order to be successful in the long run future strategic capabilities must be planned for and then sustained regardless of difficult immediate circumstances.

Firms in emerging economies are at particular risk of

turbulent environments (including volatile exchange rates, high inflation, and high interest rates) eroding their core competencies. Compared with firms in developed economies those in emerging economies are obliged to maintain a high level of flexibility to cope successfully with their environment.

For individuals in emerging economies who are innovative in efficiently creating flexibility the return to entrepreneurship should be higher than that in developed economies. Not only might flexibility be a competency leading to sustainable competitive advantage, it may also be a competency leading to survival in emerging economies.

CORE COMPETENCIES

Firm performance has been the subject of examination for as long as business has been studied. Recently core competencies have been a central theme of strategy research. This inward looking field stands in juxtaposition to the old structure, conduct, performance (SCP) paradigm which held that industry membership and behavior within that industry were the primary determinates of success. This shift in thinking has occurred as business environments have become more volatile and dynamic representations of strategy have become better explanations of real world performance than older more static representations of stabler business environments (Winter, 1999). Core competency models therefore have particular salience to firms in more

volatile emerging economies.

The management of core competencies is one of the most important strategic challenges facing a firm given their crucial relationship to superior profitability. Once created, core competencies cannot be simply stockpiled for use when needed. Rather, these core competencies require constant use to maintain corporate fitness (Teece, 1990). Thus firms wherever situated and in whatever circumstances must view their management as a strategic issue.

The maintenance of corporate fitness not only requires investment in existing competencies but also the acquisition and development of new ones. Consequently, one of a firm's key issues in maintaining corporate competitive advantage involves striking the proper balance between the development of new competencies and the improvement of existing ones (Penrose, 1959; Rubin, 1973; Wernerfelt, 1984). Examples of this tradeoff abound in firms which conduct a high level of R&D.

Highly intensive R&D firms must carefully consider what percentage of sales to plow back into research. Merck, a firm in the ethical pharmaceutical industry, routinely puts eleven percent of sales into R&D (Mahoney and Winter, 1996).

Whatever this balance between the development of new competencies and the improvement of existing ones investment in future capabilities must always continue. This is true even in

times of economic duress now being experienced by some economies in economic duress.

STATIC AND DYNAMIC PERSPECTIVES ON MANAGING CORE COMPETENCIES

Competition and non-industry environmental factors (such as exchange rates, inflation, interest rates, etc.) contribute to the dynamic nature of a firm's environment and hence to the value of dynamic representations of core competencies.

In this paper we examine how volatile exchange rates incentivize firms to look away from the management of core competencies to deal with the current crises and why this must not happen.

Firms must adapt to changes in their environment (including extreme exchange rate changes) in a timely manner. They must be proactive in building those capabilities which will be required for the future in the face of exchange rate volatility.

Due to environmental changes, core competencies in one context or historical era may not remain so in another. This may be true of some ASEAN economies as required skills for their future success have changed as a direct function of their previous success and subsequent integration in the global economy. Indonesia, Malaysia, and Thailand have been successful in attracting foreign investment. This investment has raised the standard of living in these countries but has also left their

currency values vulnerable to the presence or absence of these investment inflows.

Now exposed to global capital flows, these economies must experience the downside as well as the advantages of this global exposure and their relatively small place in it.

Speculators and hedge funds can easily drive down the value of thinly traded currencies such as exists with these small economies in the absence of offsetting investment inflows. The problem facing many companies in Indonesia, Malaysia, and Thailand is having assets denominated in local currencies while having liabilities denominated in foreign hard currencies. It is this mismatch of assets of liabilities which contributes to problems arising from the extreme devaluation of these local currencies.

Unique historical conditions, as well as causal ambiguity and social complexity, contribute to changing firm strategies (Lippman and Rumelt, 1982; Reed and DeFillippi, 1990; Mahoney and Winter, 1996). Due to their flexibility, intangible resources and capabilities are most likely to have adaptive characteristics in turbulent environments. The knowledge and savvy of managers in developing countries are important examples of these intangible resources.

Static perspectives of core competencies are applicable in extremely demanding environments, for example a firm facing a

turbulent foreign exchange market may need to focus entirely on management of that situation in order to survive in the short run. They may be obliged to raise hard currencies under distress conditions in order to satisfy their creditors. However, firms must survive in the long run as well. A firm's competitive position must not erode any more than necessary as their currencies depreciate. Protection of their strategic position is best accomplished with constant attention to their underlying core competencies and development of new ones. By employing a dynamic perspective in their strategic positioning firms both respond to new conditions and create the foundation for long-term success. Management of foreign exchange exposure for companies in Indonesia, Malaysia, and Thailand through their treasury function is a new competency which must be mastered.

The appropriate application of dynamic perspectives of core competencies depend on conditions facing the firm.. The balance between 'present and future' is reflected in the firm's level of organizational flexibility (Penrose, 1959; Wernerfelt, 1984).

TURBULENT FOREIGN EXCHANGE MARKETS

In the present global economic order international trade is increasingly important in fueling the economic growth of firms, countries, and entire geopolitical spheres. This is particularly true for developing economies dependent on the existing markets of the industrialized world.

To the degree to which foreign exchange rates are constant, change slowly, or predictably, difficulties due to fluctuations in currency exchange are minimized. Difficulties are encountered however when these markets are manipulated or otherwise unduly chaotic and interfere with legitimate economic development, trade, and growth. Such manipulation can occur easily in the thinly traded currencies of small emerging economies by large investment firms located in hard currency countries. This is what happened to the currencies of Indonesia, Malaysia, and Thailand. What is a firm to do in these circumstances?

THE IMPACT OF FOREIGN EXCHANGE EXPOSURE ON FIRM'S OPERATIONS

Traditional foreign exchange analysis has primarily focused on static terms of trade variables. For example, the merchandise trade deficit between country A and country B. Differences in factor endowments, labor rates, degree of capital intensity, etc.

Given the present liquidity of foreign exchange markets the desire to rapidly change the composition of foreign denominated assets portfolios may cause massive changes in the demand for currencies unrelated to long-term economic fundamentals. This may occur when demand for a particular currency plummets not due to underlying economic fundamentals but rather to portfolio decisions made in far off lands. These decisions may bear no

relationship to anything other than these asset allocation decisions. This set of events helped create the downturn of some currencies in Southeast Asia. Foreign investments in Indonesia, Malaysia, and Thailand slowed, starting the weakness in these currencies

Firms vary tremendously in the impact of currency exchange rates fluctuations on their present and potential profitability. At one extreme firms with both assets and liabilities denominated in the same currency have little risk¹. Our focus is on firms that are more at risk. These firms tend towards the other extreme. They have assets and liabilities which are mostly denominated in different (hard) currencies than their own. Figure 1 lists some factors which affect the currency operating exposure of *individual* firms.

¹ Although it may be impossible to avoid the effects of the macroeconomic upheaval in nations strongly affected by these volatile exchange rate fluctuations. Furthermore the draconian measures sometimes imposed by transnational organizations unnecessarily reducing domestic demand can have a deleterious effect on even otherwise sound firms and indeed entire economies.

Factor	Operating Exposure
1	Volume of Sales in Different Markets
2	Proportion of Sales in Different Markets
3	Market Structure in which Competition Occurs
4	Do Real Exchange Rates affect Operating Profits
5	Sources of Raw Materials and Labor
6	Location of Production Facilities
7	Labor and Capital Intensity of Production Processes
8	Channels of Distribution Employed
9	Countries Capital Structure and Debt Level
10	Taxes, Subsidies, and other Policies of Governments in Production and Sales locations

Table 1

To analyze the effect of volatile exchange rates on an individual firms performance strategic managers must realize that there are many internal factors which are important (such as in Table 1). While firms cannot affect foreign exchange markets themselves they may be able to mitigate the influence of those

markets on firm profitability and viability.

An important beginning to this process is for the firm to explicitly realize the importance of an ability to manage foreign exchange risk as a strategic priority. Globalization of markets and high rates of technological development have created a higher degree of macroeconomic volatility reflected in exchange rates. This volatility has an effect on the formation and maintenance of core competencies, tending to take attention away from them in the short run.

Treasury functions of corporations must do more than simply manage direct currency risk, they must also devolve their expertise to the operating unit level as capabilities to deal with currency volatility must become firm wide. Similarly, information must ascend from operating units to treasury to coordinate firm wide currency exposure and flexibility. This coordination will assist a company in times where currency valuations are volatile. The applicability of having a treasury function which operated in this way would be for firms in developing countries whether indigenous or subsidiaries of firms from developed economies.

The maintenance and development of core competencies still remains crucial in the present environment. World technological trajectories remain unaffected by localized currency volatility in the developing world. Firms located and doing business in

unaffected nations progress unabated. It simply is not a long term option for firms located in affected Asian economies to abandon development of core competencies. To do so would cede a perpetual competitive advantage to firms located elsewhere.

The issue is one of managing currency volatility in such a way that it does not materially interfere with a firm's global competitiveness. This can only be accomplished by maintaining and developing core competencies in all circumstances, even under duress.

STRATEGIC RESPONSES TO THE PRESENT ENVIRONMENT

Firms in nations with a recent history of high exchange rate volatility may find themselves in a precarious dilemma. Short term economic considerations make the efficient use of resources imperative for survival. A problem with this may be that it can result in the gutting of intangible capabilities in favor of the preservation of more tangible ones. This can also occur in firm's in developed countries where management fails to invest in such things as machinery maintenance, training, or information technology.

We say "maintain core competencies no matter what." In practice maintaining core competencies under duress is problematic but the realization that this is needed should not be. Clearly the maintenance of core competencies which give advantage in the near term will take priority over the building

of new competencies. This is done to best mitigate short-term duress. But this can only last for a short while. As in all things the long term quickly becomes the near term. Duress in the near term should set the stage for a new round of competency building based on the firms present experience. These new competencies will form the basis of future sustainable competitive advantage.

A solution to this seeming conundrum is partially reached through the realization that core competencies being knowledge based and not only do not interfere with recovery from economic setbacks, they aid in the process. In this instance reconfiguring to handle exchange rate volatility *is* the development of a new set of core competencies.

This line of logic is in fact a single application of a broader theme: core competencies cannot be sacrificed to temporary economic setbacks. Core competencies not only support future competitive advantage they are *required* for long term firm survival. To abdicate the maintenance and development of core competencies is tantamount to surrender and is appropriate only in harvest strategies.

This paper has already suggested some responses to the volatile exchange rate regimes (see Figure 1). Firms must understand their exposure in a sophisticated manner. Knowledge regarding the impact of currency depreciation or appreciation

must be integral to all levels of organizations based or doing business in non-reserve currency nations². This is particularly true for rapidly developing economies subject to the vagaries of foreign capital investment.

The role of treasury must become strategic and proactive creating the degree of flexibility which allows a firm to manage volatile exchange rate fluctuations. We are referring to firms in developing countries with dispersed geographical operations. Questions such as the location of production facilities and the ability to rapidly shift focus among markets become paramount. Issues involving labor rates, labor intensity, inflation, and cost of capital under different scenarios must be examined, projected, and whenever possible planned.

Distribution channels and market structure may be affected in these circumstances. Firms must *imagine* and plan for these

² Firms based in hard currency nations are not immune to the vagaries of currency fluctuations. This is particularly true if they have important markets in nations subject to these extreme volatility. Nonetheless hard currency fluctuations are generally less extreme and occur over a longer time period, thus being less problematical.

effects. An awareness of what drives local markets and the effect of external forces is important.

Recent high real estate appreciation in many ASEAN nations reflected portfolio decisions made by investors in America and Europe rather than local economic considerations. Local currencies were artificially high because of foreign demand for assets denominated in them. Although the policies of national governments may have contributed to the problem, when demand for new assets abruptly fell off the result were preordained.

Managers must attempt to evaluate the reasons behind the demand for currencies. Is a currency rising because that country has a merchandise account surplus or because of strong demand for investments denominated in that currency? A manager can easily see that in situations with high currency appreciation and no current account surplus that this appreciation is due to investment demand.

Care must be taken in situations where foreign portfolio decisions drive asset and currency values. Predictably, once foreign investors have arrived at their preferred exposure levels then demand for the local currency will fall off. This is a particular problem for relatively small economies as they are more vulnerable to smaller scale disturbances. It is important to note that portfolio disinvestment is not required for currencies to tumble, simply a significant drop in *new* investment.

While we prefer stability we should not view it as an end in and of itself. There are numerous examples of economies which have relatively stable exchange rates and are going nowhere with little international investment interest. Sometimes the fact that nothing is changing means nothing is happening and vice versa.

Many developing economies have used Japan as their model with its export driven orientation. The problem with this lies in the fact that even if successful one's economic fate is tied to the behavior of others. This also true when one imports great amounts of investment capital. In the first case one relies on demand for goods and services generated by others, in the second one depends on the portfolio decisions of external actors³.

Clearly, some movement towards a more balanced economy based on domestic demand might be helpful in dampening foreign exchange fluctuations. Firms can influence this collectively by adopting a strategy which increases domestic demand through such things as the extension of credit and the manufacture of products suited to the local market. This should not be done at the expense of

³ Although one should be gratified by the confidence expressed by such investments, however volatile. This is not the worst problem to have.

foreign markets but as an adjunct to it. A greater proportion of output is domestically absorbed and does not involve the foreign exchange markets. Government policy should support such a restructuring.

High domestic savings rates offer no relief from currency fluctuations and may actually be counterproductive in periods of high capital inflows from outside the country. It is certainly true that contractionary fiscal and/or monetary policy is not an appropriate response in this situation. It merely aggravates the problem since excess domestic demand *was never the issue in the first place*. In fact there is every reason to believe that stimulating the economy would be of greater value⁴.

In any event, strategic managers must understand the manner in which these dynamics play out. National governments and transnational organizations make decisions affecting the business environment and firms must be prepared to deal with these decisions, illconceived or not.

CONCLUSION

⁴ Measures to convert savings into demand are appropriate.

The recent buffeting of economies in Asia has presented local managers⁵ with some difficult strategic decisions. This paper has indicated that the continued maintenance and development of core competencies remains essential. The development of a model by which to approach exchange rate volatility is also called for. Figure 1 presents a sophisticated starting point for this type of analysis.

Exposure to fluctuating exchange rates is specific to each firm and must be dealt with uniquely. Awareness of this strategic issue must permeate the firm at all levels. Managing currency risk is not the exclusive responsibility of treasury. It must be shared with operations as well.

Historically, development of important new capabilities has arisen from necessity much more often than foresight. Toyota developed flexible manufacturing and the just in time (JIT) inventory system because of an inability to imitate American auto production techniques. DuPont originated the multi-divisional structure because of economic duress. WalMart invented its own distribution channels when traditional channels wouldn't accommodate it.

⁵ And governments.

In all these cases the skills developed to adapt to adverse situations later allowed these firms to compete advantageously with older skill sets they could not originally acquire or imitate.

It will be interesting to see how firms in countries adversely affected by recent exchange rate volatility fare. Undoubtedly some will fail, but others will prosper and those skills developed in response to the present environment may portend competitive advantage in the future. Firms should as a matter of philosophy plan to come out the present situation better than ever, not simply plan to survive⁶.

⁶ The present chicken little prospects offered by pundits regarding the ASEAN block should be taken with a healthy dose scepticism. For those with a long term perspective now may be a uniquely favorable time to invest in some of these economies.

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