Global Economic Impacts on Strategic Financial Management

By Ramona Dzinkowski

National and regional economies around the world are more closely integrated than ever before. In their financial management strategies, companies throughout the U.S., Canada, and the EU, though constrained by different legal frameworks, corporate structures, and accounting and reporting standards, must address the same set of complex global issues. At the same time, there are some uniquely American issues that financial executives will be addressing over the coming year.

These were some of the findings revealed at the annual meeting of the National Association for Business Economics (NABE®) in September. The conference was attended by some of the most well-respected economists and business leaders in the U.S., Canada, and the EU.

So what are the issues that financial executives in the U.S. and elsewhere around the world should be thinking about going forward into 2006?

1. Unanticipated shocks and the network effect,
2. Globalization and local economic impacts,
3. Complex capital markets, and
4. Impacts of Hurricanes Katrina and Rita.

UNANTICIPATED SHOCKS

First, in light of the threat of ongoing terrorist activities against Western societies, analyzing the future of business cycles, income growth, or the likelihood of different rates of return on different types of investments will have to consider the structure of global networks of all sorts—information, supply, production, and distribution.

While just-in-time inventory management and the internationalization of the production process have created significant efficiencies and cost savings, such practices have also left many companies and their customers vulnerable to unanticipated shocks.

As R. James Woolsey, former director of the CIA, explains, "We live at the center of hundreds of complex networks of all kinds, and many of them are getting more complex every day. The electricity grid, the oil and gas pipelines, refineries, the Internet, food production and delivery—it goes on and on. All of these were put together over the course of the last century or so with an eye over time to efficiency, transparency, low cost, ease of access, ease of maintenance. One thing we know from chaos theorists and network theorists is that when networks get more and more complex, even minor disturbances can create unanticipated and incalculable chaos."

The implications for financial managers everywhere is that their understanding of control systems and of financial and operational risk has to include an awareness of the vulnerability of their production, distribution, and information networks to systemic shocks that could have a significant impact, not only on the well-being of their companies but on the well-being of their customers and other stakeholders. With this view, Woolsey also stresses the importance of international cooperation and the responsibility of companies to coordinate with a variety of organizations and interests to ensure the integrity of their systems of production and distribution, particularly where they relate to the transport of hazardous materials that could be targets of terrorist attacks.

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GLOBALIZATION AND LOCAL ECONOMIC IMPACTS

A second common bond among financial managers around the globe is that changing patterns of international trade from low-production-cost countries to high-production-cost countries have made the competitive landscape highly unpredictable, particularly in low-cost consumer products industries. According to Steven G. Cochrane, managing director of Economy.com, an international economic consultancy based in the U.K., U.S., and Australia, "There are contractors out there that are ready and willing to contract goods at ever lower costs and export them around the world."

Cash management, capital budgeting, earnings volatility, and forecasting demand issues remain significant challenges for financial managers and strategists in competing domestic companies. At the same time, the potential for growth in local port areas because of increased imports of low-cost goods promises increased economies of scale for local industries, increased infrastructure investment, and new opportunities for services and construction to support ground distribution systems. In the coming year, financial strategies are expected to reflect these opportunities. This will manifest in an increase in M&A activity among manufacturing, distribution, and warehousing in these regions as companies attempt to both cut costs and capture margins by vertically integrating.

With respect to higher-value manufactured goods, they are less vulnerable to volatility in international trade patterns. Cochrane says, "Higher-value goods are more linked to the internationalization of the supply chain and are mostly interfirm trade. Because of that there's a little bit more of a stable pattern to trade, but that's also changing." The common financial management challenge in these companies comes mostly in the form of cost control. Ongoing increases in demand for inputs (commodities, machinery and equipment, steel) from Chinese manufacturers, combined with excess demand for shipping and high crude oil prices, will continue to have a significant impact on manufacturing costs in 2006, which will put sustained pressure on quarterly earnings. In fact, the NABE outlook as of September 2005 estimates crude oil to be trading at US $63 at the end of this year and US $55 at the end of 2006.

Regional impacts from globalization will continue to produce both winners and losers across the U.S. in 2006, and all industries and services supporting these regions will be affected as well. This, according to Cochrane, reflects the "re-industrialization" of America. "The re-industrialization can best be illustrated by a shift in the auto industry…. So much of it is now moving south into Tennessee, Alabama, South Carolina, and particularly becoming more important in certain areas in North Carolina. It now replaces the textile industry to a certain extent."

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At the same time, changing patterns of export trade will also benefit some regions in the U.S. more than others. Cochrane says that, "In terms of looking at the pattern of exports, there are really three broad regions that benefit the most from export trade. One is the Midwest, another is the South (Louisiana), and the other is the West Coast. These are where the value of the exports and goods is the highest. Right now, the Midwest is linked to the Canadian economy and, to a certain extent, the European economy. The South—Louisiana and Texas—largely because of its links to the oil plants in Mexico, and the Midwest largely because of its links to Asia. Going forward, the advantage of trade is going to benefit the West more than the other regions because of the high concentration of technology industries."

COMPLEX CAPITAL MARKETS

The liberalization of Chinese financial markets, combined with heavy buying of U.S. Treasury Bills, has created unprecedented levels of contagion in the international financial markets. Should China fall into economic hard times, this could put both the U.S. and EU under severe economic pressure. Some suggest that the exposure of certain countries to foreign financial shocks could result in large-scale economic disruption.

For purposes of practical corporate management, the trend toward increased contagion in global financial markets means that financial executives must be very careful to consider the interrelated employment, debt reduction, monetary policy, and exchange rate policies in the U.S., EU, and Asia when planning their own expansion, treasury, hedging, and capital management/acquisition strategies. Though this may be challenge enough for companies operating within the U.S., this complexity is enhanced for companies relying on EU markets because of wide variations in inflation and a lack of consistent economic data among European countries.

As John Calverly, chief economist and strategist at American Express in London, says, "In contrast to U.S. data where we can look at all these relationships [inflation, interest rates, unemployment] going back 10, 20, 30, or even 50 years, you can't do this in Europe because the EU area is new. And even though we can put together 'officially' the data from different countries, within a different operating regime, exchange-rate movements, inflation rates, it's not necessarily very meaningful. So one of the issues for the European Central Bank is the data, and related to that is establishing their credibility in anti-inflation policy."

IMPACTS OF HURRICANES KATRINA AND RITA

While the forecasted growth in economic output for 2006 (as measured by real GDP growth) remains unchanged at 3.4%, according to many economists, Hurricanes Katrina and Rita have had a significant impact on many U.S. companies in the short run. The crude oil platforms in the Gulf of Mexico were shut down for weeks, pipelines were ruined, and shipments were cut off for an indeterminate period of time. In addition to the immediate impact as a result of the storms, spin-off effects would be felt throughout many sectors of the economy.

According to Douglas Holtz-Eakin, director of the Congressional Budget Office, there were really two big categories of impacts that resulted. "The first are the production impacts in the area of energy with damages to the refining capacity of natural gas. There are direct agriculture impacts, certainly a big loss in housing services, and then there are broader effects that come from lower consumption both directly in the area and also from having higher energy prices drown out other aspects of household spending." Official releases from the Congressional Budget Office suggest that "production of electricity, oil, refined products, port services, housing services, manufacturing, retailing, tourism, and other consumer services will be sharply derailed for at least a few months in affected areas." At the same time, reports indicated that many financial companies had relaxed their payment requirements, waiving late fees for contractual obligations on loans and insurance payments. Preliminary estimates of insurance claims suggest that private losses could amount to more than US $30 billion, and federal flood insurance payments are also expected to be substantial.

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Spin-off impacts will be felt by industries across the country, resulting in, as we've seen, short-term hikes in energy prices and, therefore, reductions in spending on consumer goods and potential increases in raw materials prices due to the disruption in port activity. For those companies that can't pass along price increases to the consumer, profits will fall in the short run. The increased price of petroleum will have a positive impact on the bottom line of petroleum producers but short-term negative impacts on transport companies that aren't able to recoup these costs in the form of higher contract prices. Companies that will benefit in the mid-term are those that will be involved with the reconstruction of New Orleans, including rebuilding homes; business and public infrastructures, such factories, streets, and bridges; as well as stocks of consumer durables such as housewares, refrigerators, stoves, and televisions. Holtz-Eakin says, "Our building efforts and investments pickup might get the economy back to its previous trend by the second quarter of 2006."

WHAT'S NEXT?

The common ground for financial management in the coming year is complexity. The issues discussed at the NABE 2005 conference clearly demonstrate that the economies and the businesses that drive them have become intricately "networked" together by globalization. Going forward, companies around the world, while subject to local laws, regulations, and taxation, will all be impacted by the same set of complex global economic issues. At the same time, in the aftermath of Hurricanes Katrina and Rita, many companies in the U.S. have to rebuild their businesses, while others will benefit from the dramatic reconstruction of New Orleans that will ensue over the next few years. ■

Ramona Dzinkowski is an economist and business journalist living in Toronto. She would like to express her sincere thanks to the National Association for Business Economics for allowing her to participate in the 2005 Annual Conference, "Change and Competitiveness: Who Moved My Paradigm?" She invites readers to access the NABE website (www.nabe.com) for further information about this and other international NABE conferences. You can reach Ramona at rndresearch@interhop.net.