

LCBB6002 International Financial Management

Individual Report

Student Name: Miroslav Penkov

Student ID: 2133625

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1. Introduction

Managing foreign exchange risks is crucial for multinational corporations operating in a volatile global market. If these risks are not managed, severe losses can be incurred because of unfavourable movements in currency (Das and Palit, 2019). The purpose of this report is to discuss the concept of foreign exchange risk management in the context of key IFM theories and strategies. It critically examines different hedging strategies and proposals based on empirical evidence as well as real-life case studies. Lastly, the report provides some recommendations for the management of foreign exchange risks in a way that improves financial stability and performance.

2. Literature Review

International Financial Management (IFM) entails diverse theories and models useful in enhancing the efficiency of conducting financial business overseas. Some of the important IFM theories are the International Fisher Effect, the PPP or the Purchasing Power Parity, and the IRP or the Interest Rate Parity to understand the movement of currencies and their effects on the MNCs (Jeevanandam, 2020). IFM includes transaction risk management, translation risk management, and economic risk management of the foreign exchange.

Several strategies for managing these risks have been identified in the current research. Natural hedging refers to business activity strategies like the market and sourcing hedges to deal with currency risks. Forward contracts, futures, options, and swaps are typical tools used in managing foreign exchange risks. Butler (2016), notes that companies with diversified operations and strong risk management are less vulnerable to forex shocks. According to Szafarczyk (2020), financial derivatives play a higher role in managing exchange risks with a positive result in volatility.

However, empirical analysis shows that within financial hedging monetary risks are directly protected, while natural and operational strategies are beneficial due to the integration of financial and operational risks. Hence, Alfaro, Calani and Varela (2021), stated that foreign exchange risk management strengthening corporate financial stability and performance underlines its significance in the international business environment.

3. Understanding Foreign Exchange Risks

Foreign exchange risks denote the potential losses that international business organizations are likely to incur as a result of fluctuations in the exchange rate of foreign currencies (Isaac et al., 2020). There are three main types. They are:

- **Transaction risk**, which is a response to the worth of future transactions
- **Translation risk**, which has an effect on the Company's financial statements when they operate in foreign regions
- **Economic risk**, which has an impact on the market value of the Company and on its competitive position.

These risks can affect the profitability, cost and financial stability of a firm hence the need for every MNC to manage these risks for better financial health and competitive edge in the global economy.

4. Strategies for Managing Foreign Exchange Risks

Hedging of foreign exchange risks is of paramount importance to MNCs to protect their operations from the volatility of foreign exchange markets. To manage these risks, natural hedging, financial hedging, and operational strategies are used (Bergman and Rosen, 2021).

4.1. Natural Hedging

Natural hedging refers to arranging business activities that will economically offset currency exposures. For instance, a company that earns its revenue in one currency might also have its expenses in the same currency thus hedging the exposure (Oxelheim, Alviniussen and Jankensgard, 2020). Another approach is the distribution of the risks over a geographical area through operations in more than one region. An example is a European firm that sells a lot of its products in the U.S. and uses the products as a hedge against revenue in USD.

The first advantage of natural hedging is that it minimizes the use of financial markets to match operational risks with financial instruments. Nevertheless, natural hedging also has its drawbacks that include restricted ability to conduct transactions and lack of perfect offsetting of risks.

4.2. Financial Hedging

Financial hedging involves the use of financial instruments in the management of exchange risk. They range from forward contracts to futures contracts, options, and swaps.

Forward contracts are contracts that call for the purchase or sale of a currency at a fixed rate at a certain date in the future. They hold forward exchange rates which reduce risk just in case but may deny themselves earnings if exchange rates turn beneficial (Alfaro, Calani and Varela, 2021).

Futures contracts refer to exchange-traded contractual agreements for the purchase and sale of currencies at specified dates in the future. They have high levels of liquidity and standardised terms but give less freedom, and need daily revaluation which may trigger margin calls.

Futures are contracts that allow the holder to purchase or sell a currency at a given price on a specified date (Das and Palit, 2019). They give versatility and shield against unfavourable trends while allowing being involved in favourable trends. However, the costs of options such as extra premiums can be expensive.

Swaps are contracts that entail the delivery of a stream of currency payments in which a set of payments is normally involved (Szafarczyk, 2020). Swaps are flexible and can hedge long-term risks but are difficult to handle and involve the credit risk of the counterparty.

4.3. Operational Strategies

Operating strategies refer to the likelihood of modifying organizational activities to reduce currency risk. Another common strategy is diversification through operations and revenues in several currencies and geographical locations (Oxelheim, Alviniussen and Jankensgard, 2020). While this minimizes reliance on any particular currency or market, this is cumbersome to manage and synchronize.

Some of the pricing strategies include changing prices relative to the currency. This enables companies to transfer costs to consumers, and sustain margins, but impacts competitiveness and demand.

Production strategies include changing the location of production so that the costs match the revenues (Bergman and Rosen, 2021). This offsets currency risks and improves supply chain operations. But this is an expensive strategy and calls for a long-term commitment.

All of these strategies have their own benefits and drawbacks. In practice, such approaches may be employed in various combinations depending on the situation in the multinational corporation.

5. Case Studies and Empirical Evidence

Real-life examples are used in the explanation of how some of the strategies for foreign exchange risk management work in actual multinational businesses. Coca-Cola is one company that has effectively managed its exposure to foreign exchange risk through natural hedging and derivative instruments (Jeevanandam, 2020). The current revenue and costs in local currencies,

along with forward contracts, allow Coca-Cola to reduce transaction risk and ensure stable profit margins despite fluctuations in exchange rates.

The case of Toyota during the 2008 financial crisis shows the problem of insufficient risk management. The carmaker lost a lot of money because of the risks associated with the U. S. dollar and the yen (Bergman and Rosen, 2021). Natural hedging was employed through domestic manufacturing, but there was an insufficient level of financial hedging. The rapid rise of the yen resulted in significant negative cash flows, underlining the importance of considering both life-cycle hedging and natural hedge strategies.

Empirical studies back these notions. According to Alfaro, Calani and Varela (2021), firms with diverse businesses and strong risk management systems are less vulnerable to currency fluctuations. Szafarczyk (2020), also pointed out that financial derivatives help tame fluctuations. These cases and studies highlight the need to use multiple approaches to mitigate and hedge foreign exchange risks depending on the circumstances of each corporation.

6. Critical Analysis

Comparing the effectiveness of foreign exchange risk management strategies shows several strengths and weaknesses. Although natural hedging minimizes dependence on the financial markets, it provides less flexibility and does not always balance risks effectively (Jeevanandam, 2020). On the other hand, financial hedging offers specific risk management instruments which include forward contracts, futures, options, and swaps that can be used to directly offset exchange rate risks. However, such tools entail certain costs and certain levels of sophistication in financial analysis.

Research findings indicate that it is effective to use these approaches concurrently. Bergman and Rosen (2021), established that diversified operations in combination with financial hedging policies help firms cope with fluctuations in currency rates. According to Isaac et al. (2020), the importance of financial derivatives increased over the years because they help eliminate earning fluctuations due to foreign exchange risks.

Drawing lessons from the case studies from different contexts and different industries there is no one-size-fits-all solution. For example, the application of natural hedging and financial hedges is

well illustrated in Coca-Cola, especially in the beverages industry where revenues and costs can be aligned in local currency (Jeevanandam, 2020). However, the case study of Toyota Corporation during the financial crisis of 2008 shows the practicality of relying on natural hedging, especially in the automobile industry where exposures to foreign currency are high.

7. Conclusion

Effective management of foreign exchange risks is significant for MNCs to maintain organizational financial stability and competitive advantage. This report has provided an understanding of natural hedging, financial hedging, and operational hedges, and has compared their strengths and weaknesses. Future research should focus on specific cases, which aim to prove that a balanced approach is the best solution depending on the needs of a particular enterprise and the industry in which it operates. The use of natural and financial hedges should be coupled with operational hedges in managing currency risks by multinational corporations. Adopting these best practices will improve their capacity to manage fluctuating exchange rates and sustain high levels of financial performance in the international environment.

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