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**BA BUSINESS MANAGEMENT**

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## INTRODUCTION

Exchange rates fluctuate constantly, creating risks for multinational corporations in terms of their profitability, cash flow and, above all, their financial stability. Therefore, foreign exchange risk management is very important for proper international financial management.

Several strategies are reviewed in this report for MNCs to adopt in order to manage their exposure to foreign exchange risks, reviewing their effectiveness through theoretical and empirical data.

Ultimately, a shared comprehension of these tactics and their practical ramifications will be provided, providing MNCs with knowledge on how to offset unfavourable fluctuations in exchange rates.

The topics of discussion will include diversification of investments, accelerated and delayed coverage, and coverage under long-term contracts.

# FOREING EXCHANGE RISKS

Is the chance that the two currencies' exchange rate will more negatively impact the specific company that is being considered (Babbel, 1997, p 642). The wealth of the company may decrease as a result of an exchange rate shift. According to the type of exposure, it can also grow its wealth in cases where the shift is favourable. There exist three distinct domains of exchange rate risk: transaction risk, economic risk, and translation risk.

## Transaction Risk

Foreign exchange transaction risk arises from variations in exchange rates between the time a transaction is made or recorded in a foreign currency, such as the dollar, euro, etc., and the time it is paid. When purchasing or selling items, a multinational may encounter such delays, which may have an impact on its accounts payable or receivable. For example, US consumers can purchase cruise packages from Alicante Cruises, a Spanish company, at US currency costs. Alicante Cruises receives invoices from multiple US suppliers for goods and services in US currency. Because it only processes returns in euros, Alicante Cruises is subject to changes in currency rates. (Madura, 2018).

## Economic Risk:

When a company's prosperity could be impacted by changes in the kinds of changes that are made, it is exposed to a risk, in this case an economic one. This risk seems to be associated with longer-term risks due to fluctuations in change types. For example, The majority of Alicante Cruises' expenses are expressed in euros. The majority of its earnings are expressed in US dollars. Let's say there is a notable increase in the value of the Euro relative to the US dollar. It is quite doubtful that Alicante Cruises will be able to raise the US dollar costs of its cruise packages because the cruise industry is a very competitive one. As a result, the net cash flows of Alicante Cruises, expressed in euros, will be impacted (Eun & Resnick, 2014).

## Translation Risk:

An organisation that has assets or obligations denominated in foreign currencies—that is, in a currency other than its reporting currency—faces this risk. For example, the assets and liabilities of Alicante Cruises are expressed in US dollars. Alicante Cruises is required to combine its subsidiaries' financial results into one statement once a quarter. It is necessary to convert any assets and liabilities denominated in USD to their equivalent in euros. There may be an accounting gain or loss as a result of the translation because various accounting rules apply to different accounting items (Shapiro, 2013).

Multinational corporations may find it challenging to implement effective foreign exchange risk management methods since the application of these risks may not yield expected financial results.

## THEORETICAL FRAMEWORK

### Overview of Relevant IFM Theories:

There have been several attempts to both forecast and explain the relationship between two national currencies. As a result, we will quickly go over the connections and the supporting data from science.

### Interest Rate Parity (IRP):

Funding costs for international funding with a simultaneous forward market hedging of that position will be comparable to domestic financing if IRP holds true.

$$F_0 = S_0 \times \frac{(1 + i_c)}{(1 + i_b)}$$

**F<sub>0</sub>** = Forward rate (quoted now)

**S<sub>0</sub>** = Current spot rate

**i<sub>c</sub>** = Interest rate in country c

**i<sub>b</sub>** = Interest rate in country b

### Purchasing Power Parity (PPP):

The exchange rate between two currencies is the same as the relationship between their purchasing capabilities.

$$S_1 = S_0 \times \frac{(1 + h_c)}{(1 + h_b)}$$

**S<sub>1</sub>** = Expected spot rate in period 1

**S<sub>0</sub>** = Current spot rate

**h<sub>c</sub>** = Expected inflation rate in country c

**h<sub>b</sub>** = Expected inflation rate in country b

### **International Fisher Effect (IFE):**

Suggests a direct relationship between nominal interest rates and currency rates.

These ideas shed important light on how interest rates, inflation, and other economic variables affect currency movements. By creating effective strategies, multinational companies can safeguard their financial interests in the global economy.

## **TECHNIQUES FOR CONTROLLING EXCHANGE RATE RISKS**

Exchange rate risk reduction solutions apply to a large number of international corporations. Some of the common techniques are listed below.

### **1. Using forward contracts as a hedge**

- a. These are agreements to purchase or sell a predetermined quantity of foreign currency at a predetermined exchange rate at a future date. Because transactions are locked at the currency rate, this technology helps international corporations cover transaction risk by removing ambiguity (Shapiro, 2013).

- b. **Benefits:** They offer cash flow security. • Due to their widespread availability, execution is simple.
- c. **Limitations:** Counterparty risk; little flexibility (the corporation cannot profit when the spot exchange rate on the settlement date is better than the forward exchange rate).
- d. As an illustration, Nestlé is a global food and beverage corporation that conducts business in multiple currencies. Nestlé employs forward contracts to hedge against currency risk. Nestlé may use a forward contract to lock in the exchange rate in the future and so lock in the value of those payments in its native currency, the Swiss franc, if it anticipates receiving payments in a foreign currency, such as the dollar. Shapiro (2013).

## 2. Leading and Lagging

- a. This entails modifying the cash flow schedule to capitalise on intended fluctuations in currency rates. When there is a predicted positive movement in the currency rate, leading expedites payments or collections; when an expected negative movement occurs, lagging delays them (Shapiro, 2013).
- b. **Benefits:** radically enhances cash flow management; the business benefits from advantageous fluctuations in currency rates.
- c. **Restrictions:**
  - i. Exchange rate fluctuations need to be understood.
  - ii. If payment conditions are changed too frequently, it can be frustrating or strained to have relationships with suppliers or consumers.
- d. Leading and lagging can be used by a business like Unilever to maximise cash flows between its European operations and its UK headquarters (Eun and Resnick, 2014).

### 3. Diversification of currencies

To lessen the impact of unfavourable fluctuations in exchange rates in a single currency, multinational corporations engage in currency diversification by spreading their activities and investments over multiple currencies, such as the euro, the dollar, etc.

Companies can lower the risk that changes in exchange rates will have an impact on their financial performance by diversifying their portfolio (Shapiro, 2013).

- a. **Benefits:** Currency diversity reduces volatility.
- b. **Limitations:**
  - i. Managing multiple currencies can be very difficult due to their multiplicity.
  - ii. The danger of exchange rate fluctuations remains.

The approach taken by HSBC, which spreads its exchange rate risk by operating in multiple countries and currencies, is an illustration of currency diversification (Allayannis and Weston, 2001).

## EVALUATION OF THE STRATEGIES

The multinational company's size, structure, kind of operations, and currencies in use are some of the elements that determine which technique to adopt. Each technique has advantages and disadvantages.

Although they might be expensive or rigid, forward contracts offer a more direct and predictable protection against transaction risk. Tactics like forecasting and lag approaches mostly depend on precise exchange rate forecasting.

More operational measures like currency diversification call for a high level of internal structural alignment.

The best course of action for managing the many facets of currency risk is to have a customised strategy rather than combining all techniques.

For short-term hedging, a big, international corporation like Airbus might use forward contracts. The secret is to strike a balance between expense, difficulty, and efficacy, as long as the tactics selected are in line with the organization's overarching goals for risk management.

## **CONCLUSION**

Multinational corporations should be aware of the dangers related to currency fluctuations. Multinational corporations in particular need to be aware of these risks and put suitable hedging techniques into place to maintain a steady and robust funding source. A comprehensive approach that prioritises individualised exchange rate risk management will be one of the key pillars in the creation of this strategy. This can be achieved through the use of forward contracts for hedging, advances and lags, or currency diversification. Multinational companies will be more successful in accomplishing their goals, which can be summed up as realising the exoticism of the business, once they are comprehended and under control.

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