



INTERNATIONAL FINANCIAL MANAGEMENT

LCBB6002



**ASSESSMENT 1: MANAGING THE FOREIGN EXCHANGE
RISKS FOR A MNC**

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IMPORTANCE OF INTERNATIONAL FINANCIAL MANAGEMENT FOR MULTINATIONAL COMPANIES

According to Eiteman et al (2016), multinational companies heavily rely on international financial management to successfully operate across diverse countries and currencies. A crucial aspect of international financial management is the effective handling of foreign exchange risk. This entails comprehending and minimizing the influence of currency fluctuations on the company's operations and financial performance. In addition, international management assists multinational companies in making well-informed choices about capital budgeting, financing, and investment strategies across different nations. Multinational companies can maximize shareholder value by efficiently managing their financial resources across various markets, optimizing their capital structure, and reducing capital costs.

FOREIGN EXCHANGE MARKET

According to Eun & Resnick (2017), since it offers a platform for trading and exchanging currencies from different nations, the foreign exchange market is crucial for multinational corporations. This market enables businesses to expand their global operations, reduce financial risk, and engage in cross-border business transactions. For multinational corporations, the foreign exchange market is essential because it affects funding, cash management, and investment strategies. Currency exchange is often necessary for multinational corporations that engage in international trade, investment, and financing. Companies can handle their foreign currency risks and conduct international transactions by converting one currency to another through the foreign exchange market. By using alternative techniques like forward contracts and options, multinational corporations can also use the foreign exchange market to manage the risks associated with fluctuations in exchange rates. By protecting their revenue, earnings, and cash flow from unfavourable currency fluctuations, businesses can increase the predictability and stability of their finances. The foreign exchange market is essential for multinational corporations to secure funding in addition to facilitating transactions. Businesses can access international capital markets and obtain funds in a variety of currencies through forex transactions, supporting their working capital needs, capital investments, and international expansion.

Additionally, by providing them with access to a range of currency options and financial tools, the foreign exchange market aids multinational corporations in efficiently managing their cash. They are able to minimize transaction costs and optimize their liquidity as a result. The interdependence and volatility of the global economy underscore the significance of the foreign exchange market for multinational corporations. Companies that grow internationally and conduct business internationally must manage currency fluctuations and exchange rate risk well in order to stay profitable and competitive. For multinational corporations to

effectively take advantage of opportunities and lower risks in the global business environment, they need to have a solid understanding of the foreign exchange market and its workings (Bekaert, 2013).

CHALLENGES EXPERIENCED BY A MNC

Multinational corporations encounter numerous obstacles when dealing with foreign exchange markets. Exchange rate risk is a significant challenge, as it involves the possible influence of currency fluctuations on a company's financial performance and profitability. Currency fluctuations can negatively impact a company's financial stability by influencing its revenue, expenses, and ability to forecast future cash flows and earnings. Managing multiple currencies and transaction costs pose additional challenges for multinational companies in foreign exchange markets, which can then hinder their planning and strategic decision-making abilities. Companies need to effectively handle and mitigate their currency risk in order to minimize the negative consequences of fluctuations in exchange rates on their financial outcomes. Companies face challenges in foreign exchange markets due to the complexities of complying with diverse regulations and legal requirements across different countries. Political and economic instability in foreign markets can pose challenges for multinational companies when it comes to handling foreign exchange risk. Government policy shifts, alterations in trade agreements, or shifts in economic conditions can abruptly result in currency volatility and uncertainty. Consequently, corporations may face challenges in effectively handling their exposure to foreign exchange risk (Bodnar & Wong, 2003).

INTERNATIONAL FINANCIAL MANAGEMENT THEORIES

As stated by Dornbusch (2010), multinational companies can utilize various theories of international financial management to efficiently handle their financial resources within different countries.

Multinational companies with a varied group of shareholders are more equipped to handle financial market instability and risks, as per the diversified stock ownership theory. The theory proposes that in order to reduce the negative effects of risks associated with specific countries on their financial performance, multinational corporations should promote ownership by investors from various nations. A multinational company can aim to attract investment from different global investors, in order to expand its shareholder base and minimize the consequences of unfavourable events in a particular market.

The concept of purchasing power parity (PPP) states that over time, the exchange rates between two nations should converge to a level that balances the prices of the same goods and services in both countries. Multinational corporations can utilize this theory to make well-informed choices regarding pricing and cost management in various countries. A multinational company in the US and China can

utilize PPP to assess its product pricing in both markets and make necessary adjustments to stay competitive.

STRATEGIES USED BY MNC

Multinational corporations encounter substantial foreign exchange risk as a consequence of conducting business functions across various nations and being susceptible to diverse currencies. In order to effectively handle these risks, corporations utilize a range of strategies. These include implementing currency hedging techniques, diversifying their operations, and employing financial derivatives.

Currency hedging is a strategy that entails mitigating the risks posed by fluctuations in exchange rates by employing financial tools like forward contracts, options, and swaps. These instruments work to safeguard against unfavourable movements in currency values. By engaging in this practice, companies can secure advantageous exchange rates, which in turn helps mitigate the negative consequences of currency fluctuations on their financial performance (Buchanan, 2017).

One of the strategies that multinational companies use to reduce the risk of foreign exchange is by diversifying their operations. Operating in multiple countries with distinct currencies allows companies to decrease their dependence on a particular currency and mitigate the repercussions of fluctuating exchange rates on their overall business performance. This approach aids in safeguarding the stability of their operations irrespective of currency fluctuations (Bartov et al, 2018)

Multinational companies also employ financial derivatives, such as currency futures and options, for the purpose of effectively handling the risk associated with foreign exchange. These financial instruments provide companies with the ability to manage and mitigate risks associated with fluctuations in exchange rates, in that way safeguarding their profitability against any unfavourable shifts in currency values.

FACTORS THAT ARE INFLUENCING THE FOREIGN EXCHANGE RISKS

According to Pike (2015), effective management of foreign exchange risk is crucial for multinational corporations to reduce the likelihood of suffering financial losses. Risks associated with foreign exchange can be influenced by a number of factors, including exchange rate fluctuations, global geopolitical events, and current economic conditions. When it comes to foreign exchange risk, exchange rate fluctuations are very significant. The value of a multinational company's assets and liabilities designated in different currencies can be impacted by fluctuations in exchange rates. These variations are a major factor in figuring out the company's

financial situation. This may negatively impact the company's financial performance and reduce its ability to compete in international markets.

The global economic climate that exists in different countries has an impact on international exchange as well. Exchange rates can be impacted by a number of variables, such as interest rates, inflation rates, and the general health of the economy. As such, the financial standing of multinational corporations operating in those specific nations may be impacted by these fluctuations.

Geopolitical events, such as trade disputes or political instability in different countries, can also impact foreign exchange. It can be difficult for multinational firms to anticipate and manage their exposure to foreign exchange risks when there is uncertainty surrounding geopolitical events because it can lead to fluctuations in currency markets.

These elements highlight the complex and varied nature of the risks that multinational firms face when dealing with foreign exchange. By actively understanding and carefully monitoring these influences, businesses can improve their risk management strategies to reduce the negative effects of foreign exchange fluctuations on their financial performance.

MANAGING FOREIGN EXCHANGE RISKS

To ensure success, organizations engaged in international business operations must give priority to managing foreign exchange risks. When fluctuations in exchange rates adversely affect the financial results of companies engaging in cross-border transactions, foreign exchange risk arises. Diverse tactics can be implemented by organizations to manage foreign exchange risks efficiently. Monitoring and analysing exchange rate movements can help companies manage risk effectively by enabling them to make informed decisions and take prompt actions to reduce potential losses. Organizations need to consider both the macroeconomic factors affecting exchange rates and the unique circumstances of their business operations in various countries. To effectively implement a foreign exchange risk management strategy, one must have a thorough grasp of the mechanisms and dynamics of the worldwide currency markets. Additionally, a proactive attitude is needed to identify, measure, and tackle potential risks.

CONCLUSION

In conclusion, managing foreign exchange exposure risks is essential for multinational companies operating in the global marketplace. Effective risk management strategies can help multinational companies reduce the effects of foreign exchange rate fluctuations on their financial performance and cash flows. Organizations must thoroughly evaluate their exposure to foreign exchange rates and establish effective risk management strategies to protect their profitability and

competitiveness in the global business landscape. It is crucial to stay updated on recent advancements and trends in global currency markets to make well-informed choices. Taking proactive measures to manage the risks associated with foreign exchange exposure is crucial for ensuring financial stability and attaining sustainable growth in the global economy.

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