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Introduction

Foreign exchange risk arises from the fluctuations in exchange rates. It can affect the financial performance of multinational corporations (MNCs) because they are engaged in international transactions (Jeevanandam, 2020). After the recent Covid pandemic, multinational companies significantly face foreign exchange risk. Several companies have been forced to shut down their businesses from different markets because of the sudden price drop of the currency. This report will assess the foreign exchange risks and how multinational companies deal with those risks. Different UK based multinational companies will be assessed in this report to get vital information's about how those companies overcome foreign exchange risks.

Literature Review

Foreign exchange risk management is a vital aspect of international financial management for multinational corporations (Jeevanandam, 2020). If proper action plan is not developed about the foreign exchange risk, then multinational organizations significantly affected by it and their sustainability become impossible. This section reviews relevant theories and key concepts that highlight the strategies MNCs adopt to manage their exposure to foreign exchange risks.

Hedging theory is one of the key theories in foreign exchange risk management. This theory is used to offset losses in investments by taking an opposite position in a related asset (Eun et al., 2021). For example, forward contracts use allow the multinational corporations to lock an exchange rate for the future transactions which providing assurance in the cash follow. So if the currency rate significantly down in the future then, it does not impact the revenue of the multinational corporations. Similarly, futures contracts provide a uniform way to hedge against future exchange rate fluctuations. On the other hand options contracts offer the flexibility to benefit from favourable exchange rate movements while providing protection against adverse changes. Each contract has vital advantages to ensure the multinational corporation's profitability and sustainability, based on the situations and requirements appropriate contract needs to select.

Speculation is another appropriate theory in foreign exchange risk management, which is different from the hedging (Madura et al., 2018). Through using this theory, multinational organizations can get higher profits but it also has significant risk because predicting exchange rate movements is challenging. MNCs can use this theory when they believe that they have the accurate information's in to currency trends. But speculations are generally riskier than the hedging because it focuses more on the gains rather than the potential risks. Considering the associated risks is vital for the long term sustainability.

Currency diversification is another important concept (Eun et al., 2021). This theory suggests keeping the assets into different currencies. Which reduce the overdependency from one specific currency. For example, if all the assets have remained in one currency then reducing that currency price significantly impact the business operations and overcoming from those losses often impossible. Currency diversification strategy is specifically useful for MNCs with global operations, as it allows them to balance the risks associated with different currencies and markets. Overall, all the theories that above mention has advantages as well as disadvantages, based on the situations and requirements appropriate theory needs to select.

Foreign Exchange Risk Management Strategies

Developing effective foreign exchange risk management strategy is vital for any kind of multinational corporations who deal in different currencies. UK MNCs use various strategies to reduce these risks, including hedging through financial instruments, natural hedging, currency swaps and operational adjustments (Shapiro and Hanouna, 2019). In this section, some UK-based multinational companies adopted strategies will be discussed to know how they protect themselves from the foreign exchange risks.

Most of the UK MNCs use hedging to manage their foreign exchange risks. UK MNCs use forwards contracts to lock an exchange rate which provides assurance of cash flows (Madura et al., 2018). For example, BP is one of the largest multinational companies of the UK which often uses forward contracts to hedge against fluctuations in foreign currency (bp global, 2023). When BP expects to receive revenues in foreign currencies such as U.S. dollars then the company enters that deal into forward contracts to sell those dollars at a fixed rate. Which reduces the chances of losses and ensures that the company gets its expected amount. This approach is specifically beneficial for managing large-scale and long-term projects where exchange rate stability is crucial for maintaining profitability.

Another key hedging instrument is futures contracts, which are standardized and traded on exchanges. For example, Rolls Royce, a leading manufacturer of aircraft engines, uses futures contracts to hedge against unfavourable currency movements, specifically when dealing with major currencies like the U.S. (Rolls-royce.com, 2024). dollar and the euro. Through using currency futures, the company locks a future exchange rate which ensures its revenue remains stable even if the pound price declines as compared to the other currency. This stability in the revenue is very important for large companies' sustainability.

Currency swaps are another modern tool used by UK MNCs to manage foreign exchange risk. A currency swap involves exchanging cash flows in different currencies between two parties. Vodafone is one of the largest telecommunications companies in the world which used currency swaps to manage its exposure to different currencies (Vodafone.com, 2020). For example, Vodafone swaps its pound-denominated debt for euro-denominated debt with another company that has opposite exposure. Through this swap, the company reduces the currency fluctuations risks.

Lastly, UK MNCs adopts operational strategies to reduce currency risks. This strategy involves shifting production or adjusting prices. For example, Jaguar Land Rover is a renowned British automotive company which has adjusted its production and pricing strategies in response to currency fluctuations (Jaguarlandrover.com, 2024). After the Brexit, the pound price was significantly reduced which affecting the cost of imported materials. In response, Jaguar Land Rover increased production in countries like Slovakia where costs were lower and adjusted pricing in different markets to maintain its profit margins. By shifting the production locations and adjusting the price of the cars, the company resolve the problems of pounds price downs.

Critical Analysis

The effectiveness of the foreign exchange risk management strategies varies depending on the specific needs of the multinational corporations (Jeevanandam, 2020). While strategies like hedging through forward contracts, futures and options provide valuable protection against adverse currency movements but these strategies also have limitations. Multinational companies cannot get the extra advantages if the exchange rate positively increases because the rate of exchange was defined at the start. This is particularly observe in industries with highly unstable cash flows, where predicting future currency needs accurately can be challenging.

On the other hand, options contracts offer more flexibility which allowing companies to benefit from favourable currency movements while protecting against adverse shifts (Eun et al., 2021). But the premium costs associated with options can be extensive which making them a costly choice for risk management. The cost of using options for hedging must be justified by the level of risk exposure. If options are not properly aligned with a company's actual business needs then there is a risk of uncertain exposure. In the real life context, in the 2008 financial crisis, those companies which depend heavily on the options for speculation rather than genuine hedging suffered significant losses when the markets turned against them.

Natural hedging and currency swaps offer alternative strategies to align operational cash flows with currency exposures (Madura et al., 2018). For example, a leading retail company Tesco effectively reduce the needs for financial hedging by matching its revenues and costs in the same currency. But this approach also has limitations because all the business are not perfectly align their inflows and outflows because of the geographic and operational limitations. Vodafone uses currency swaps to manage long-term exposure but these can be complex and costly specifically in unstable markets.

In comparison, hedging strategy offer more immediate and measurable protection against currency risk but they need to carefully manage to remove over hedging or speculative risks (Eun et al., 2021). While operational strategies may be more sustainable in the long term but they are often slower to implement and require substantial investment.

Conclusion

In conclusion, this report assesses how multinational's corporations deal with foreign exchange risks. As multinational companies operate their business in the different countries so for ensuring profitability and reduce the chances of losses, companies often adopt foreign exchange risk management strategy. This report assesses which foreign exchange risk management strategies UKs multinational companies such as BP, Rolls Royals, Vodafone, etc use. Overall, this report highlights that selecting the right risk management strategy is very important.

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