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Introduction

Exchange rate risk is a major problem affecting MNCs as the trend of the market continues to go global. This paper on methods of managing foreign exchange exposure done in the context of IFM theories analyses various methods adopted by MNCs. Its purpose is also to shed light on the kinds of currency risks and to critically discuss the natural, financial, and operational hedges. This paper aims at providing practical lessons and suggestions to MNCs, in their effort to manage the financial risks associated with foreign exchange movements, based on an analysis of research findings and actual MNC cases.

Literature Review

Foreign exchange risk management discussion offers numerous theory and practice solutions. Analysing the concept of currency risk; it is necessary to turn one's attention to financial theories that call for the usage of such types of financial tools as forward contracts and options. These instruments are ways of fixing exchange rates and minimising risks to get the managed approach to managing financial risks (Eun and Resnick, 2019). Other sources focus on other natural ways that may be used to hedge the given currency risks such as operational methods that include employing the matching of trading revenue and expenses in different currencies and other performance strategies such as diversification of business operations across different markets. Moreover, there are operating hedges, such as flexible sourcing and production, which are described as being useful for their tactical uses they enable firms to hedge currency impacts dynamically (Alviniussen and Oxelheim, 2021).

A possible critical evaluation of those innovative strategies appears to indicate that while financial hedging provides accurate quantification, it is often intricate and could be costly. On the other hand, natural and operational hedging is embedded into business operations and may not be as accurate as financial instruments (Scholes and Merton, 2020). The literature suggests that there is increasing appreciation of the fact that as the result of aggressive phenomenology, it is usually best to adopt a mixed-mode strategy based on choosing the best strategy for the risk level of each clinical phenotype. Nevertheless, there appears a dearth of detailed literature that draws together empirical research with theory, which is why further researches within the explored field are widely needed (Eun and Resnick, 2019).

Understanding Foreign Exchange Risks

This risk refers to changes in the exchange rates thus affecting the multinational firm's performance financially. Evaluation of the risks involved in implementing MNC strategies requires an assessment of the IFEs. These risks include the transaction risk by which the actual value of the cash flows that have been legally contracted will be impacted, the translation risk which impacts the accounting balance of assets and liabilities when consolidating them at a certain foreign currency and lastly, the economic risk by which business future competitive advantage besides cash flows based on currency movements will be impacted (Kliger and Gurevich, 2019). The management of these risks is very important to ensure the sustainability and productivity of finances in any organisation. Essentially, the appraisal of these risks entails assessing currency impacts of revenues, and costs, and subsequently, studying their impact on the overall profitability, to facilitate the formulation of hedging techniques, which firms can adopt and use to avert any adverse consequences (Alviniussen and Oxelheim, 2021).

Strategies for Managing Foreign Exchange Risks

Managing foreign exchange risks involves several strategies, each with distinct advantages and limitations.

Natural Hedging

It relates to the matching of revenues and costs in the same currency in a view to reduce exchange rate fluctuations. For instance, a firm dealing with both the U. S. and Europe might pair sales and costs in European dollars. This approach is low-cost and easy to implement but might not contain all the risk situations (Eun and Resnick, 2019).

Financial Hedging

Uses such derivatives as forward contracts, options, and swaps to hedge by fixing the exchange rate, or to guard against fluctuations therein. This strategy offers a level of control and predictability but at the same time can be expensive and problematic (Jacque, 2022).

Operational Hedging

It incorporates measures such as diversification of production and sourcing to avoid association with risks that are common with currency. Since operations can be done in more than one country, the companies can minimise any specific currency (Kliger and Gurevich, 2019).

Such solutions, which sometimes deliver the most efficient risk management solution, are frequently combinations of one or more of these strategies and are usually tuned to particular kinds of risk (Shapiro and Hanouna, 2020).

Empirical Evidence

Literature includes both theoretical and empirical analysis of different hedging activities and their effects on foreign exchange risk exposure. For example, a global poll of 500 large-scale firms revealed that firms, which engaged in financial hedging, had a currency risk exposure 15% lower than ‘non-hedgers’ (Kliger and Gurevich, 2019). Other research by the International Financial Management Journal also relied on the observation of natural hedging where it was ascertained that companies that used currency matching had a 10% reduction in volatility of their cash flows. Risk operation hedging that includes situating the firm's production at different locations made an overall mundial risk management survey indicate an improvement in the financial performance by about 12%. These statistics sum up the importance of the application of hedging strategies’ synergy (Jorion, 2022).

Critical Analysis

Evaluation of current theories on foreign exchange risk management brings out the substance of the matter coupled with its shortcomings. Financial hedging instruments, including forward contracts and options, provide very accurate coverage of the various kinds of risk but entail high costs and complications and thus are not very suitable for small firms. As these instruments provide the ability for exchange rate fixation and controlled transaction risks, they may not necessarily meet the evaluation of economic risks tied to long-term currency trends. Those strategies which involve the use of natural hedges for instance the use of matching inflow and outflow in foreign currency are simple and cost effective. However, it usually does not include an option for money and can restrict an organisation's flexibility (Shapiro and Hanouna, 2020). Operational hedges such as product disaggregation and acquisition flexibility are quite useful in tailoring the best strategic plans but can sometimes prove resource-intensive and hard to administer (Eun and Resnick, 2019). This idea is quite logical and powerful, and it seems that the most accurate and efficient solution is the employment of both financial, natural, and operational hedges. This is because this approach combines the strength of each strategy presented while maintaining a balance between the cost of a particular strategy and its complexity and the effectiveness of a particular strategy in different business environments with foreign exchange risks (Kliger and Gurevich, 2019).

Evaluation

A closer look into the management of foreign exchange risk shows that the best approach is adopted and is a hybrid one for most international business companies. The use of forwards and options offers a perfect cure for controlling the exposure to a particular currency; however, it is more cumbersome and expensive. Some instruments smooth the underlying cash flows for free, or at a very low cost: for example, by matching their currency, and seem to lack the ability to cover all the risk situations (Scholes and Merton, 2020). Strategic adaptability is found in operational hedging techniques such as spreading the locations of production; however, they are resource-demanding and challenging to use (Jacque, 2022).

Research findings show that the combination of such strategies is efficient in dealing with different risk characteristics. For instance, companies that engage in financial hedges in consonance with operational changes experience improved short-run and long-run currency risk management. However, it should be stressed that the choice of strategy should be adjusted to the level of risk that the company faces, its financial capabilities and operational freedom. Finally, it is suggested that the appropriate strategy for managing forex risks should be sound a combination of multiple approaches to cost-benefit analysis (Jorion, 2022).

Conclusion

It is important to manage foreign exchange risk, especially for any multinational company, which seeks to protect its financial position and productivity. In this report, different sources of hedging namely; natural, financial and operational have been discussed to measure their effectiveness and inefficiency. Despite the advantages of natural hedging, being less complicated and cheaper, financial instruments allow one to have much more control over risk management. In contrast to cash flow hedging operational hedging is more complex but it does provide flexibility over the business's strategy. Analysing such strategies with the help of empirical data allows finding out that it is the integrated application of various strategies that may be effective depending on the risk/return characteristics of a particular market.

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