



International Financial Management (LCBB6002)

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Introduction

International Financial Management (IFM) entails the oversight and management of financial assets and liabilities on a global scale, while appraising the impact of multinational negotiations on a company's financial performance. The increasing worldwide integration of corporations has made International Finance Management (IFM) an important area of study, resulting in the development of numerous theories and frameworks designed to comprehend and evaluate the intricacies and possibilities within the domain of global finance.

According to *Buckley* (2009), the theory of international trade and investment is a key concept in IFM. "The theory concerning international trade and investment holds a paramount position within the realm of International Financial Management (IFM). The subject matter of this study explores the complex relationship that exists among currency exchange rates, trade balances, and the dynamics associated with international investments. Additionally, the theories of purchasing power parity (PPP) and the international Fisher effect are crucial concepts that shed light on the impact of exchange rate fluctuations on decisions regarding international trade and investment.

Another noteworthy area of investigation within the field of International Financial Management (IFM) involves the theory concerning international capital budgeting. This theory provides guidelines on how multinational corporations should analyze and make investment decisions across different countries. It appropriately recognizes and integrates influential elements such as political susceptibility, fluctuations in exchange rates, and ramifications of taxation.

Strategies, theories Adopted by Multinational Corporations regarding exchange risks

Foreign exchange risk refers to the potential financial disadvantage that can emerge as a consequence of fluctuations in currency exchange rates. When conducting international transactions, the participation of corporations, investors, and financial institutions in transnational trade, investments, and transactions can be profoundly impacted. The risk arises from the unpredictability associated with the future assessment of one currency in comparison to another. Types of Foreign Exchange Risk can apply.

Transaction Risk This happens when a company purchases goods from a foreign supplier with the price stated in the currency of the supplier. The purchaser will need to provide a higher amount in their domestic currency to meet the previously agreed-upon price should the currency utilized by the supplier appreciate. Transaction exposure affects one party in a foreign currency transaction, typically the business involved. Using local currency for invoice payments decreases company risk. Despite the risk of exchange rate fluctuations, finance professionals use hedging techniques to minimize losses.

Translation Risk Refers to how currency exchange can impact financial reporting, including the potential impact of exchange rate fluctuations on a company's equities, assets, liabilities, or income. Foreign subsidiaries of parent companies using the currency of their host country pose this risk. The parent company may suffer losses from currency translation of subsidiary financial statements.

Economic Risk Unexpected currency fluctuations impact a company's market value through operating exposure or currency risk. Future cash flows, foreign investments, and earnings of a company are all affected by this. Economic exposure has a significant effect on a company's market value. Multinational companies are more vulnerable if they have many overseas subsidiaries and deal with foreign currencies. Globalization made all businesses more vulnerable economically. The consequences are extensive and long-lasting and because of unforeseen fluctuations in exchange rates, hedging economic exposure is challenging.

Strategies of multinational corporations

In order to efficiently mitigate their vulnerability to the fluctuations in currency exchange rates, multinational corporations frequently employ diverse strategies. Some of the typical approaches include:

Hedging. Multinational corporations often strive to reduce foreign exchange risks through the strategic alignment of their foreign currency revenues with foreign currency expenses or liabilities. This technique, frequently known as natural hedging, assists in curbing the way changes in exchange rates affect a company's ability to make money.

Currency Diversification. An alternative method involves enlarging the company's exposure to different currencies by including a diverse range of currencies in its portfolio for both assets and liabilities. Through the implementation of diversification strategies, the corporation possesses the capability to alleviate the overall impact that unfavorable currency fluctuations may have on its financial position.

Forward Contracts: Multinational corporations often utilize forward contracts to minimize their vulnerability to potential foreign exchange risks. These contracts allow the company to establish a predetermined exchange rate for an upcoming transaction, thereby providing protection against adverse changes in currency exchange rates.

Netting. Multinational corporations can utilize netting as a proactive approach to risk mitigation, wherein they can merge their liabilities and assets denominated in various currencies. This methodology can reduce the general vulnerability to risks associated with foreign exchange fluctuations.

Theories of International Financial Management

The renowned theories encompassing the Mundell Fleming model, the Fisher effect, interest rates equality, purchasing power parity, and the international Fisher effect hold significant prominence in academic circles.

Mundell-Fleming Model: Studies how monetary and fiscal policies influence exchange rates and capital flows in an open economy. It showcases the role of economic factors in determining policy effectiveness.

The Fisher effect States that nominal interest rates change in response to anticipated inflation. The theory is vital in understanding how global finance's interest rates, inflation, and exchange rates are connected. It states that the difference in interest rates between two countries equals the difference between their forward and spot exchange rates. This theory affects how we perceive the connection between interest and exchange rates.

According to purchasing power parity theory, identical goods in different countries should have the same price in a single currency, assuming no transaction costs or trade barriers. This theory helps understand exchange rates and enables price comparison across countries.

The International Fisher effect holds that interest rate disparity between two nations should correspond to fluctuations in exchange rates within a specific timeframe. This theory is essential for comprehending global finance's interest rates and exchange rate fluctuations.

Factors Influencing Foreign Exchange Risk

Supply and demand interactions in the market. Supply and demand dynamics in the world's currency markets primarily impact changes in exchange rates. Various factors, namely disparities in interest rates, imbalances in trade, movements of capital, geopolitical occurrences, and the sentiment of investors, can all influence alterations in the values of currencies.

Inflation, interest rates, and GDP are examples of economic considerations. Currency exchange rates are subject to significant fluctuations based on economic indicators, including GDP growth, interest rates, and inflation rates. Interest rates are comparatively high compared to other countries, which may attract foreign investors and cause the currency to appreciate. The devaluation of a nation's currency, on the other hand, can happen when interest rates fall.

Changes can significantly influence foreign exchange rate fluctuations in *government policies, regulations, and political stability*. Several political and regulatory factors, including capital controls, trade policy changes, geopolitical tensions, and election results, can influence exchange rate movements.

Ways to Manage Foreign Exchange Risk

Make arrangements with a bank or foreign exchange service provider to **establish a forward contract**. The best way to manage foreign exchange risk is to use this option. The payment will be received in US dollars without being affected by currency exchange rate changes. Exporter must confirm the precise amount of foreign currency, payment date from importer, and currency exchange execution date before starting the procedure. To manage payment uncertainties, exporters can seek assistance from a bank or service provider to organize a window forward contract. This gives the exporter a delivery timeframe within the given dates.

The exporter explicitly recognizes foreign currency payments exclusively upon **receiving the total cash payment in advance**. This particular choice is notably suitable for transactions of a smaller scale and for forming initial connections with importers. It is characterized by its simplicity, complete reimbursement guarantee, and exceptional security level. However, certain importers may hesitate due to their aversion towards making upfront cash payments.

Establish a correlation between the incoming and outgoing foreign currency. The exporting company chooses to open a foreign currency bank account. The goal of this strategic move is to improve transactions and lower currency exchange costs. This opportunity is perfect for American exporters who use a shared foreign currency to trade internationally. When considering this option, it's vital to assess the costs and personnel needed to manage a foreign currency bank account. It's important to carefully note gains or losses from currency conversion in official financial records. These drawbacks could greatly affect.

Develop a well-defined risk management policy. It is imperative for an efficient policy on managing foreign exchange risk to precisely establish the level of currency risk that a company is prepared to undertake. Moreover, it should develop comprehensive guidelines for handling such exposures and explain the specific roles and responsibilities of the individuals participating in the risk management process.

Conclusion

One primary issue that companies operating in global markets must address is the potential risk of fluctuations in foreign exchange rates. The unpredictable nature and unstable volatility in exchange rates can substantially impact a business, affecting its expenses, earnings, and overall profitability. Therefore, companies must be highly vigilant and proactive in implementing various financial tools and strategic risk management strategies to manage and minimize their vulnerability to foreign exchange risks effectively.

In conclusion, it is of utmost importance for businesses to efficiently handle the risks associated with foreign exchange if they want to be successful in the global marketplace. In addition to this, companies must assess and analyze their susceptibility to currency fluctuations continually. By doing so, they can protect their financial stability and ensure they retain a competitive advantage in the market.

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