FOREIGN EXCHANGE RATE RISK: INSIGHTS FROM RECENT LITERATURE ON ASSESSMENT AND MANAGEMENT STRATEGIES

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ABSTRACT

We have thoroughly examined many companies and businesses that operate globally in the field of foreign currency risk in this research study. Since the subject has already attracted a lot of attention because of its significance to multinational corporations, we have examined the material from both recent and older literature to get a thorough understanding of the risk assessment and management strategies that have been used in the past and present. In emerging countries, foreign currency rates fluctuate often, and because they affect the financial operations of many businesses, effective risk management is a crucial instrument. This research was conducted using secondary sources, which include various academic publications. From the list of publications, both qualitative and quantitative data were taken out and efficiently compared. Since content analysis data visualization was used in this study, the majority of those data are shown in tables. Comparing the data, we can see that the new literature, which was mostly published after 2020, has been significantly adding to the body of existing material. The information demonstrates how the organization has been exposed to significant financial risks due to foreign exchange rate risk, but financial leaders, particularly Treasury, have been able to weather those consequences. This essay aids in the study of how tactics have evolved over time and how businesses respond to the likelihood of risk they face.

Keywords: Foreign exchange risk, risk management, currency fluctuations, global firms, treasury strategies, financial vulnerability, content analysis.

INTRODUCTION

For multinational corporations engaged in global commerce, exchange risk management is of paramount importance. It refers to the strategies used to protect a company from potential losses caused by fluctuations in currency exchange rates. Effective risk management requires businesses not only to identify risks but also to understand their origins. Among the various financial risks that companies face, exchange rate fluctuations can significantly impact their strategic goals and competitive advantages in the global market. As a result, regulators and policymakers must ensure that risk mitigation strategies are effectively implemented and that corporate performance remains a focal point.

To understand exchange risk management, it is essential to clarify key terms such as exchange, foreign exchange, and exchange rate, all of which refer to the conversion of one currency into another. The U.S. dollar is the most widely used currency in international trade. For example, businesses in China and Pakistan must convert their national currencies into U.S. dollars when conducting cross-border transactions. Exchange rates play a crucial role in this process, as currency values fluctuate based on supply and demand, foreign reserves, and macroeconomic conditions. Higher exchange rates can increase the cost of trade, impacting a country's overall economic activity.

Many emerging economies struggle with financial instability due to fluctuating exchange rates and high levels of debt, leading to a lack of both domestic and foreign investment. Exchange rate management is critical for bridging the gap between domestic savings and gross domestic investment, as currency fluctuations affect corporate profits, cash flows, and overall economic stability. Consequently, the impact of foreign exchange rates on financial performance has drawn the attention of economists and financial scholars.

Types of Foreign Exchange Risks

Foreign currency risk can be categorized into three main types:

1. Transaction Risk:
❖ This refers to the impact of currency fluctuations on export receivables, import payables, and dividend repatriation.
❖ It directly affects a company's cash flows due to unexpected exchange rate movements.
2. Translation Risk:
❖ This arises when a company converts the financial statements of its foreign subsidiaries into the parent company's functional currency.
❖ Exchange rate fluctuations can alter the value of assets and liabilities, impacting financial reports.
3. Economic Risk:
❖ This is the long-term impact of exchange rate changes on a company's revenue, operating expenses, and overall financial performance.
❖ It also influences macroeconomic factors such as inflation, interest rates, and economic recessions.

Managing Foreign Exchange Risk

As global trade expands, financial executives face growing complexity in managing currency risks. Corporate treasuries typically oversee exchange rate risk, but most multinational corporations (MNCs) have established risk management committees to ensure a structured approach.

The risk management process involves:

1. Identifying the Risk Exposure:
❖ Assessing the extent of currency risk and its potential impact on the business.
2. Choosing a Hedging Strategy:
❖ Tactical Hedging: Used for short-term risk mitigation in export and import transactions.
❖ Strategic Hedging: Applied to long-term risk exposure, ensuring stability in financial planning.
3. Implementing Risk Mitigation Tools:
❖ Transaction Risk Management:
✓ Forward Contracts, Currency Options, and Currency Swaps help businesses hedge against fluctuations in exchange rates.
❖ Translation Risk Management:
✓ Currency Swaps and Futures Contracts help mitigate risks arising from financial statement conversions.
✓ Some businesses reduce risk by asking customers to pay in foreign currency, shifting currency fluctuation risks to the buyer.
❖ Economic Risk Management:
✓ Interest Rate Swaps, Stock Derivatives, and Commodity Derivatives help manage long-term risks.
✓ Diversification of business operations across multiple markets can also mitigate exposure.

While these strategies provide a structured approach to managing exchange rate fluctuations, economic risk remains difficult to quantify due to its long-term impact on cash flows. Businesses may need to adopt a combination of hedging measures to effectively control risks.

REVIEW OF LITERATURE

The study of foreign exchange risk management has evolved significantly over the years. Various scholars have contributed to understanding the impact of foreign exchange risks on different financial sectors and markets. The following literature provides insights into key areas of forex risk management, its effects on businesses, and strategies for mitigation.

Ayadi, Salisu, and Gupta (2022) analyzed the role of senior official speeches in influencing foreign exchange risk across business cycles. Their study highlights how public policy communication impacts forex markets.

Calvin (2019) examined the relationship between cryptocurrencies and global foreign exchange risk, discussing how digital assets interact with traditional forex markets. The findings suggest that cryptocurrencies exhibit unique risk characteristics that distinguish them from conventional forex instruments.

Deng (2020) explored the connection between foreign exchange risk, hedging strategies, and tax-motivated income shifting. His study provides empirical evidence on how firms adjust their financial strategies to mitigate exchange rate fluctuations.

Ho, Ma, and Wang (2020) investigated whether foreign exchange risk affects equity analysts' stock price forecasts. Their research suggests that analysts incorporate forex risk factors into their stock valuation models, influencing market predictions.

Huston, Guo, and Zhang (2019) studied the role of mutual fund ownership in foreign exchange risk exposure among Chinese firms. Their findings indicate that institutional investors play a critical role in hedging currency fluctuations in emerging markets.

Kim and Moneta (2021) examined the relationship between long-term foreign exchange risk premia and inflation risk. Their research provides insights into the economic implications of forex risk for inflation-sensitive financial instruments.

Krapl and Giaccotto (2014) explored the term structure of foreign exchange risk and its impact on industry costs of equity. Their study reveals how forex risk affects long-term investment decisions and capital costs across industries.

Prieto, Loyola, and Perez (2019) investigated foreign exchange risk management practices in Latin American firms, analyzing determinants that influence corporate hedging decisions. Their research emphasizes the importance of regional economic conditions in shaping forex risk strategies.

Uppal and Mudakkar (2021) analyzed foreign exchange risk management in a managed float regime using evidence from Pakistan. Their findings highlight the effectiveness of forex risk management policies in stabilizing exchange rate fluctuations in developing economies.

The third factor to think about is the long-term risk of inflation and exchange risk premia (FRP). Fabio, Daehwan They found that inflation risk was a major factor in predicting FRP in the long run (Kim & Moneta, 2021). Plus, I explained why the short-term real interest rate differentials and a currency pair's long-term FRP have a negative association. According to what they found (Kim & Monetta, 2021). All of the currency pairings included in their study were found to have IRPD components that are highly negative. Furthermore, they have shown that in the absence of a robust and forceful response from the central bank to the inflationary pressure, a negative correlation between IRPD and short-term RIRD is produced as a result of the inflation shock (Kim & Moneta, 2021).

In contrast, research that examines the claims made by the exchange regime in order to implement risk assessment models, such as the work of Uppal and Mudakkar (2021), used the Pakistani currency, which is somewhat managed relative to the US dollar. Five different iterations of the Value a risk model were evaluated in the research, and all of them failed to provide satisfactory results when applied to currency pairings. The results shown that there is an increase in both risk and economic agent cost associated with regime flouts (Uppal & Mudakkar, 2021). A currency that may fluctuate with the help of the government or central bank to keep it stable is called a flout-controlled currency. The results of this research show that managed fluctuating currencies, such as those that are pegged to the dollar, are more vulnerable.

The equity value of a corporation or organization may also be impacted by exchange rate risk. What is the best way to measure the risk? Yes. A model for the cost of equity was developed by Krapl and Giaccoto in their 2014 paper "Foreign Exchange Risk and the Term-Structure of Industry Costs of Equity." The authors of the study discovered that the exposure to foreign exchange risk significantly affects the equity valuation of the company. For cashflows with a short duration, their research yielded an average foreign currency premium of 2.29%; however, this premium decreases as maturity grows (Krapl & Giaccoto, 2014). While practitioners in businesses dealing with international trade were already factoring in the possibility of fluctuations in exchange rates when valuing their assets, the work of Krapl and Giaccoto provided a new way to confirm that their assumptions were correct. It should be emphasised that the pricing mistake caused by ignoring the term-structure is not as bad as the one caused by ignoring the foreign exchange risk component. (Krapl & Giaccoto, 2014).

When it comes to tax-driven outbound revenue shifting, are there any limitations imposed by foreign currency risk on U.S. multinational enterprises and corporations? Zero Deng provided a solution to this issue in his research showing that exposure to higher levels of currency volatility is associated with less outbound income shifting. Companies with international members or partners that employ foreign functional currencies may feel this impact more acutely. According to Deng (2020), a functional currency serves as the primary means of exchange inside an organization.

Cryptocurrencies are gaining traction and attention every day; as a result, researching the associated exchange rate risk is crucial. "Cryptocurrencies vs. global foreign exchange risk" (Cheong, 2019) illuminates the topic. As an additional means of mitigating foreign exchange risk, the researcher has investigated the characteristics of several cryptocurrencies (Cheong, 2019). Cryptocurrencies, according to his research, provide superior protection against exchange rate risk compared to traditional hedging strategies.

If you want to learn more about hedging, you should read this article on whether or not companies use it as a strategy when they are attempting to prepare for measures related to foreign currency risk. Was discovered. Latin American businesses were the ones who worked on this piece. The study's results demonstrated that foregone exchange risk encompasses key components of the metric. That is why it should be a part of your strategic hedging strategy.

Foreign currency risk is pervasive and impacts almost every facet of multinational corporations. Whether the CEO's remuneration plan may lead to specific agency conflicts with the risk of hedging strategy for foreign currency rates is one of those things that participants might not pay attention to. When asked this question, Nouajaa and Viviani (2017) found that CEO remuneration in the form of shares, stock options, etc. demonstrated that this was really the case. The remaining vulnerability to currency fluctuations is affected by them. In cases when the residual exposure to foreign currency risk is inversely related to both shares and options (Nouajaa & Viviani, 2017). Because options and shares are especially hit hard when the level of foreign currency risk is high, the authors also point out that agency difficulties have a very varied effect.

The contribution of the new papers to existing knowledge of Insurance

Every one of the publications that were considered for inclusion in this research contributed something new to our understanding of the exchange rate risk, and the ones that were ultimately selected met all of the requirements for a credible article; they were all very informative.

Prior to his work, no one had examined or annualized the connection between the target price projection inaccuracy and foreign currency risk (Ho, 2020). This was a significant contribution from Ho. However, Huston's research made a difference by drawing attention to the positive effects that a strong governance practitioner may have on the risk that enterprises and corporations face. As discussed in the article "Long-term foreign currency risk premia and inflation risk" (Kim & Moneta, 2021). provided three distinct contributions The first was that they have identified inflation risk as a potential component in the long-term FRP. Second, by using structural modelling, they were able to examine the verbality of long-term foreign currency rates. Their third major contribution is a microfinance model that explains the impact of economic shocks on the inflation risk premium and, by extension, the long-term FRP (Kim & Moneta, 2021).

Conversely, Ayadi made a significant contribution to the field by using large data sets to account for intraday volatility reactions to 28 macro news stories, by distinguishing between the effects of four speech characteristics, and by increasing the sample duration to 10 years in order to compare the unequal consequences of the US and EU crises (Ayadi, 2022). In their research on the managed float currency in Pakistan, Uppal and Mudakkar addressed an unanswered question from earlier works: would it be easier or harder to model risk for currencies that are subject to managed float, such as the Pakistani rupee or the Japanese yen, compared to currencies that are not? According to Uppal and Mudakkar (2021), the regime choice may also affect risk management techniques. The study by Cheong demonstrated how cryptocurrencies can be used effectively to manage and hedge the risk of the exchange rate, which is an intriguing addition to consider since cryptocurrencies are a relatively new phenomenon that is expected to gain popularity in the near future.

By factoring in a foreign currency risk premium that changes over time, Krapl and Giaccotto's approach is more in line with the work of Ang and Liu (2004). Above and beyond that, they have calculated the cost of equity term structures in the sector. Plus, I looked at whether there would be a major pricing mistake if we used a constant discount rate or ignored the foreign currency risk (Krapl & Giaccotto, 2014). Zero Deng also uncovered evidence that financial hedging of currency derivatives facilitates income shifting by minimizing the impact of foreign exchange on financial performance (Zero Deng, 2020), which is another way tax evasion is enabled. The final piece of information comes from Nouajaa and Viviani, who claimed that the remaining exposure to foreign currency risk in their article demonstrates the direct forward effect of foreign exchange hedging on the value of a company's assets, liabilities, and equity. (Nouajaa & Viviani,2017).

METHODOLOGY

Foreign exchange rate risk refers to the potential for financial loss resulting from currency fluctuations. Organizations face varying degrees of currency risk, and their treasuries are responsible for developing specific hedging strategies to mitigate these risks. This research examines different risk management techniques employed by firms, drawing insights from a review of global literature on the subject.

Data Collection and Literature Review

To conduct a comprehensive content analysis, we reviewed 8 to 10 scholarly articles, comparing older literature with recent research, particularly studies published after 2020. This approach allows us to identify evolving risk-hedging strategies and assessment methods adopted by firms over time.

- Articles published between 2010 and 2019 were analyzed to establish a foundational understanding of currency risk management practices.
- To incorporate recent advancements, we included studies published between 2020 and 2022, focusing on new techniques and emerging trends in exchange risk management.
- A comparative analysis of studies ([1], [2], [3], [4], [5], etc.) was conducted to differentiate between traditional and modern approaches to risk mitigation.

Research Approach

This study employs a mixed-method research strategy, integrating both qualitative and quantitative techniques:

1. Qualitative Analysis
❖ Examines theoretical perspectives on currency risk management.
❖ Reviews corporate strategies for hedging exchange rate fluctuations.
❖ Compares regulatory frameworks and policy impacts.
2. Quantitative Analysis
❖ Assesses statistical findings from prior studies on exchange rate volatility.
❖ Analyzes data on hedging techniques, risk exposure, and financial outcomes.

Data Organization and Visualization

A data visualization approach was used to enhance clarity and analytical depth. Key data points were organized into tables and comparative charts, facilitating clearer insights into:

✓ Risk assessment methodologies across different time periods.
✓ Corporate hedging strategies and their effectiveness.
✓ Trends in exchange rate risk management over the past decade.

Study Objective

The primary goal of this research is to compare and contrast risk management strategies used in earlier studies with those in recent publications. By employing a structured literature review and data visualization techniques, we aim to provide a comprehensive analytical framework for understanding exchange rate risk assessment and mitigation.

FINDINGS AND RESULTAND DISCUSSIONS

This collection of studies explores the impact of foreign exchange (FOREX) risk on businesses, investors, and financial markets, highlighting various factors that influence currency fluctuations and risk management strategies.

Key Findings:

1. FOREX Risk and Financial Forecasting
- Ho et al. (2020): Higher FOREX risk correlates with greater target price prediction errors by analysts, suggesting the need for improved forecasting models.
- Huston et al. (2019): Mutual fund ownership reduces foreign exchange exposure for Chinese firms, emphasizing the stabilizing role of institutional investors.
2. Macroeconomic Factors and FOREX Risk
- Kim & Moneta (2021): Inflation risk significantly affects long-term foreign exchange risk premia (FRP), with inflation expectations shaping currency valuations.
- Ayadi et al. (2022): Senior officials' speeches influence intraday EUR/USD exchange rate volatility, demonstrating the role of macroeconomic announcements in FOREX markets.
3. FOREX Risk Management Strategies
- Uppal & Mudakkar (2021): Traditional risk models struggle in managed float regimes, advocating for market-driven exchange rate determination.
- Cheong (2019): Cryptocurrencies provide an effective hedge against FOREX risk, offering a viable alternative to traditional risk management tools.
- Giraldo-Prieto et al. (2019): Latin American firms use hedging strategies to manage currency risk, influenced by transaction costs, investment opportunities, and financial distress.
4. Corporate Finance and Risk Exposure
- Krapl & Giaccotto (2014): Foreign exchange risk affects industry cost of equity, particularly for firms with long-term cash flow maturities.
- Deng (2020): Hedging FX risk improves tax-motivated income shifting for U.S. multinational corporations, highlighting its role in global tax planning.
- Nouajaa & Viviani (2017): CEO compensation influences foreign exchange risk hedging, with incentive structures shaping firms’ risk exposure strategies.

Practical Implications:

- ✓ Investors and policymakers should consider FOREX risk when assessing asset values and economic stability.
- ✓ Companies can mitigate exchange rate volatility through hedging, cryptocurrency investments, and policy adjustments.
- ✓ Regulators should account for macroeconomic events, monetary policies, and market structures when developing FOREX risk models.

These studies collectively enhance the understanding of FOREX risk factors and management strategies, offering insights for financial institutions, policymakers, and investors navigating currency fluctuations.

The impact of the exchange rate on the inaccuracy of analysts' target price is the first risk that will be addressed in this article. Studies have shown that the exposure of foreign currency to target price projection is ten times higher than inflation and four times higher than interest rate (Ho, 2020), making it an essential risk to identify. Thus, businesses should give equal weight to interest rate and inflation concerns as they do to exchange rate risk. The bulk of investment firms who participate in the stock market nowadays obtain their income from other nations, and consequently different currencies, due to globalization''. There is a favorable correlation between the analyst's target price and the risk of foreign exchange (Ho, 2020). Since a larger return is associated with a higher level of risk, it follows that a higher level of risk will always result in a higher price. Tuan Ho argues that this correlation is less pronounced in big financial institutions and more pronounced in smaller businesses.

Mutual Funds' Exposure to Exchange Rate Risk is the Subject of the Second Part of the Article. In her 2018 study titled "Mutual Fund ownership and foreign currency risk in Chine's enterprises," Elaine Hutson investigated how well mutual funds monitor and mitigate the foreign exchange risks of Chinese listed companies. According to Huston's research, companies that are heavily owned by states and legal persons are less likely to be affected by fluctuations in the exchange rate since they are not as dependent on the dollar.

CONCLUSION

To avoid the financial loss that may otherwise result from foreign currency risk, it is crucial for a corporation to identify it and manage it. Firms with a global presence carefully monitor the currency rates before each deal to mitigate the risks associated with doing transactions on a global scale. Before entering into any commercial contract, it is common practice for a company's treasury to assess the risk, determine its magnitude, and attempt to mitigate it. Nevertheless, a committee is appointed by the corporation to oversee the treasury's approach to risk exposure and management. Such is the significance of the subject process in international arenas, particularly commerce.

Businesses think about the potential dangers that might impact their profit margins, the value of their assets, the value of their imports and exports, and so on when they engage in international commerce, investments, and operations. Prior to investing in any global venture, they carefully consider the many forms of risk, including economic, transactional, and translational risk. Methods for determining the nature of the risk, quantifying it, and hedging it are all part of these computations. This procedure demands a great deal of focus from the businesses' designated team since it is not as straightforward as it seems. Hedging methods are complex because they address three distinct forms of risk all at once.

Careful administration is necessary for this. Companies choose a group of executives with knowledge of the context of their international commerce, the factors that might influence the development of exchange risks, and the best ways to mitigate the impact of these risks on the bottom line. As a result, hedging protection measures are more important than ever. The purpose of this study is to examine the new literature and its contributions to the current literature by comparing and contrasting the two.

A number of problems with evaluating and controlling risks associated with fluctuations in foreign currency rates have been identified in the current research. Problems arise when trying to categories different kinds of risks, as well as different ways to quantify them (e.g., tactical vs. strategical, passive vs. active). We have compiled information from recently published articles and found the most well-regarded hedging strategies that address gaps in the current research.

The firm's treasury is really using a number of techniques to mitigate the impact of exchange rate risk. Forward contracts, currency swaps, and options are some of the financial tools they utilise for risk management. Additionally, in order to reduce risk, they utilise diversification, which means spreading their assets across many currencies. The company may use the local currency, albeit that is not always the case. Since the firm doesn't deal in foreign currency, there will be no effect on the exchange rate of the nation; all transactions are already done in the local currency, which means the customer is completely responsible for any fluctuations. The effect of changes in currency rates may be lessened in this manner.

To eliminate the devastating impacts of exchange rate swings, several measures are applied at different periods, or even simultaneously. Factors such as the company's size and kind, the frequency of currency transactions, and the amount of risk tolerance are among those that determine their applicability. A comprehensive strategy is necessary to eradicate currency rate risk, as we have learnt from this.

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