

Understanding Foreign Exchange Risk Exposure in Importer Companies

Tejao Vuahs*

Department of Finance and Banking, University of Passau, Innstrabe 27, D-94032 Passau, Germany

Introduction

One of the most pressing and significant economic challenges faced by many nations is the instability of foreign exchange rates. This issue particularly impacts individuals or groups who have financial obligations denominated in foreign currency while their income is in the domestic currency. This situation is especially precarious for those engaged in international trade, including exporters and importers. When the domestic currency appreciates in value, exporter groups are at risk of losing a portion of their earnings. Conversely, importer groups face the possibility of financial losses if the domestic currency depreciates. The volatility in the Foreign Exchange (Forex or FX) market introduces an element of uncertainty into everyday transactions, especially for importing products, as it entails foreign exchange rate risk. This dynamic makes financial planning for these groups more complex, with monetary outcomes becoming unpredictable due to the influence of exchange rate fluctuations [1].

Description

The primary aim of this paper is to illustrate a hedging method using FX forwards to effectively mitigate the foreign exchange risk exposure encountered by importer companies. This is particularly pertinent concerning the costs incurred in foreign currencies for their products. The analysis and strategies outlined in the paper are demonstrated through the example of a global online retail store that conducts its sales in USD while sourcing its products from various countries worldwide, thus exposing itself to FX risk. Specifically, the focus is on the company's procurement of products from European countries, highlighting the challenge of hedging against the USD/EUR exchange rate risk. It's important to note that importers of foreign goods are actively involved in the forex market, making them vulnerable to currency rate fluctuations [2].

The findings presented in this paper have relevance not only for importer companies on a global scale but also for any organization exposed to FX risk. Although the hedging strategy showcased in this paper is specifically applied to the USD/EUR exchange rate risk, the methods and applications developed can be readily adapted for any FX currency pairs. The subsequent section offers a comprehensive literature review that delves into relevant materials concerning the strategies employed in this paper, with the aim of narrowing down the scope for a more thorough understanding of the theories and applications used. Moreover, the paper utilizes historical price data, employing descriptive statistics such as diagrams and histograms. Additionally, the distribution fitting technique, Pearson's Chi-squared (X²) Test, is employed to make inferences regarding the probability distribution of the historical data. Such statistical analysis plays a crucial role in generating plausible future prices for a specific company [3].

***Address for Correspondence:** Tejao Vuahs, Department of Finance and Banking, University of Passau, Innstrabe 27, D-94032 Passau, Germany; E-mail: vuahs989@gmail.com

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Received: 02 September 2023, Manuscript No. Jamk-23-118012; **Editor Assigned:** 04 September 2023, PreQC No. P-118012; **Reviewed:** 16 September 2023, QC No. Q-118012; **Revised:** 20 September 2023, Manuscript No. R-118012; **Published:** 28 September 2023, DOI: 10.37421/2168-9601.2023.12.450

The section on foreign exchange risk hedging strategy introduces the theoretical foundations of hedging techniques for minimizing FX risk exposure. It briefly outlines three major approaches for managing FX risk exposure, which include maintaining stable profit margins, natural hedging and hedging through forward contracts. The latter approach involves the use of derivative instruments, specifically forward contracts. Forward contracts are financial instruments that enable companies and individuals to set today the terms of future transactions, thereby securing a predetermined exchange rate for future transactions. The final section addresses the central research question of the paper: whether hedging with FX forwards or allowing FX exposure to fluctuate is more advantageous. This is achieved by calculating average daily costs with and without hedging. In conclusion, the key results are reiterated, highlighting the preferred approach of allowing exposure to float, with an expected reduction in daily costs of \$67 USD. Furthermore, the paper acknowledges the significance of further research, which may encompass derivatives markets and hedging techniques, especially the usage of forward and futures contracts [4,5].

Conclusion

In conclusion, this paper compiles a diverse range of literature encompassing discussions on foreign exchange derivatives, valuation, hedging with and without derivatives, as well as insights into managing FX risk with derivatives. Notable references, such as Brown, provide valuable insights into coping with FX risk using derivatives, while Campbell, Medeiros and Viceira contribute to the understanding of global forex hedging. The references mentioned above define essential advancements in the realm of FX risk exposure issues, its hedging and the statistical background crucial for implementing hedging strategies based on real-world business scenarios. For future research, it is advisable to focus more on amalgamating theoretical foundations and mathematical models to gain a clearer understanding of the practical utilization of hedging techniques. This approach can offer a more comprehensive view of how these techniques are applied in real-world scenarios, enriching the existing body of knowledge in this field.

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How to cite this article: Vuahs, Tejao. "Understanding Foreign Exchange Risk Exposure in Importer Companies." *J Account Mark* 12 (2023): 450.