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Risk Management in International Business

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WITH THE ADVANCE OF technology, communication and transportation has improved tremendously, thereby pushing forward the development of international business. In the age of globalization, the line between "foreign" and "domestic" investing has become increasingly blurry. However, investing in foreign markets takes on additional risk, as well as opportunities, compared with what investors normally face when investing at home. This article outlines two of the most significant risks in international business and describes risk management techniques for confronting them.

- **Currency Exchange Rate Risk** is a financial risk posed by an exposure to unanticipated changes in the exchange rate between two currencies. The exchange rate between currencies fluctuates over time, and can lead to unexpected gains or losses. Currency exchange rate risk includes transaction exposure, economic exposure, and translation exposure.

1. Transaction Exposure
A firm has *transaction exposure* whenever it has contractual cash flows (receivables and payables) whose values are subject to unanticipated changes in exchange rates due to a contract being denominated in a foreign currency.

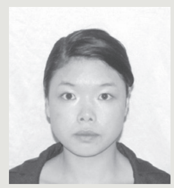
Transaction Exposure Example:

An American company borrows ¥100 million for a term of 1 year at effective annual interest rate of 3% in the international financial market. After getting the loan, the company changes ¥100 million into $1 million at the current exchange rate $1=¥100. One year later, the company needs ¥103 million to repay the Yen denominated loan. If the exchange rate between Dollar and Yen has changed to $1=¥90, then the company will pay about $1,144,444 to buy ¥103 million. Actually, the company will pay about $144,444 more and the real effective annual rate is (1,144,444 -1,000,000)/1,000,000* 100% =14.44%.

2. Translation Exposure
A firm's translation exposure is the extent to which its financial reporting is affected by exchange rate movements. Translation risk involves the revaluation of foreign assets that are held in a foreign currency because foreign currency exchange rates vary over time. This kind of revaluation will create an exchange loss or gain.

Translation Exposure Example:

A Chinese company has $1 million in its current account in a bank, the exchange rate is $1=¥6.14, which equals 6.14 million Chinese Yuan. If the dollar depreciates and Chinese Yuan appreciates, say the exchange rate $1=¥6, then the $1 million can be transferred into ¥6 million. During the translation, the money in the current account has reduced by 140,000 Chinese Yuan.



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3. Economic Exposure
Economic exposure (also known as *operating exposure*) is the risk of a company's market value changing from unexpected exchange rate fluctuations. When the currency exchange rate rises or falls, the cost of production and sale price can be affected by the change which may in turn affect profits.

- **Country Risk** includes political risk and economic risk that may affect its businesses and result in investment losses

1. Political Risk
Political risk can be defined as the risk of losing money due to changes that occur in a country's government or regulatory environment. Acts of war, terrorism, trade barriers and military coups are all extreme examples of political risk.

2. Economic Risk
Economic Risk is the risk associated with a country's financial condition and ability to repay its debts. Economic indicator movements in the foreign country such as GDP, unemployment, purchasing power, inflation, etc. are important measurements for economic risk.

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RISK MANAGEMENT TECHNIQUES

The first step in risk management is to identify the risk. Discussed below are strategies for foreign currency exchange risk management and country risk management:

- **Foreign Currency Exchange Risk**

First, if you have the option to select the billing and pricing currency, consider your national currency to conduct the business. This way you can eliminate exchange risk however many companies may not have this option. If not, add a margin buffer to any invoice quoted in a foreign currency or create a contract by which the buyer and seller share the risk of significant fluctuations in foreign exchange rates between the time the invoice is generated and the date on which the payment is made.

Second, utilize financial instruments like forwards, futures, and options to hedge the risk. Some of the most commonly financial instruments and are discussed below:

1. Foreign Exchange Forward
In the forward contract, the amount of the transaction, the delivery date, and the exchange rate are all tailored in advance, no exchange of money takes place until the actual settlement date. The two parties in the contract have the obligation to buy and sell in foreign currency. Foreign exchange forward contract is a way of locking in the foreign exchange rate.

2. Currency Future
Currency future is somehow similar to foreign exchange forward which determines a delivery date, the size of the contract and a fixed foreign exchange rate. However, there are some important differences between them. The most obvious one is that the price of the contract changes daily in currency future. For forwards, there is only one transfer at maturity date. Compared with forward contracts, future contracts avoid default risk which possibly takes place in forwards.

3. Currency Option
A currency option is a contract that allows the contract holder to have the right to buy or sell the currency at an agreed price. American options permit the holder to exercise the option any time before the expiration date. In contrast, European options only permit the exercise of the option at the expiration date. The advantage of currency option is that the holder does not have to buy the foreign currency in the agreed price in the contract when the market foreign currency exchange rate is lower than the agreed the price. However, the cost of buying the options is much higher than forwards and futures.

- **Country Risk Management**

Before investing in a foreign country, investors should assess the possibility of the investing country's political risk (the stability of politics and attitude towards foreign investment) or estimate the foreign country's current economic condition and future development via foreign country's GDP, unemployment rate, purchasing power, inflation. Using this information, investors can then predict how much loss the political or economic risk might bring. After the assessment, if the investing country satisfies the investing condition, the investor should negotiate the investment environment and draft an investment agreement. After all the pre-investment work, the investor also can look for investment insurance to lower the risk.

CONCLUSION

In international markets there are more risks to carry, however at the same time, there are more potential gains you can receive. Before you decide to invest in a certain country's market, ensure you understand the currency exchange rate and political risks associated with the investment by performing due diligence on the country's economic, political and cultural condition.

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