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WHY GLOBAL MULTI NATIONAL CORPORATIONS DO NOT NEED TO USE DERIVATIVES TO HEDGE AGAINST CURRENCY FLUCTUATIONS ?

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Abstract: **Most International Finance textbooks will explain how Large Multi National Corporations can hedge against currency fluctuations using internal and external techniques without asking the basic question do they need to. Some textbooks reference a standard loss in reported profits due to currency fluctuations without explaining what the term reported profits means or considering the impact or lack of impact on the Organization. This paper discusses whether these "paper" reported profits are relevant and whether there is really a need for Global Organizations to hedge.**

Keywords: **International Finance, Currency hedging, Internal and external currency hedging, Reported profits, exchange risk.**

1. BACKGROUND

The foreign exchange over the counter market is the world largest free market and dwarfs all other markets.

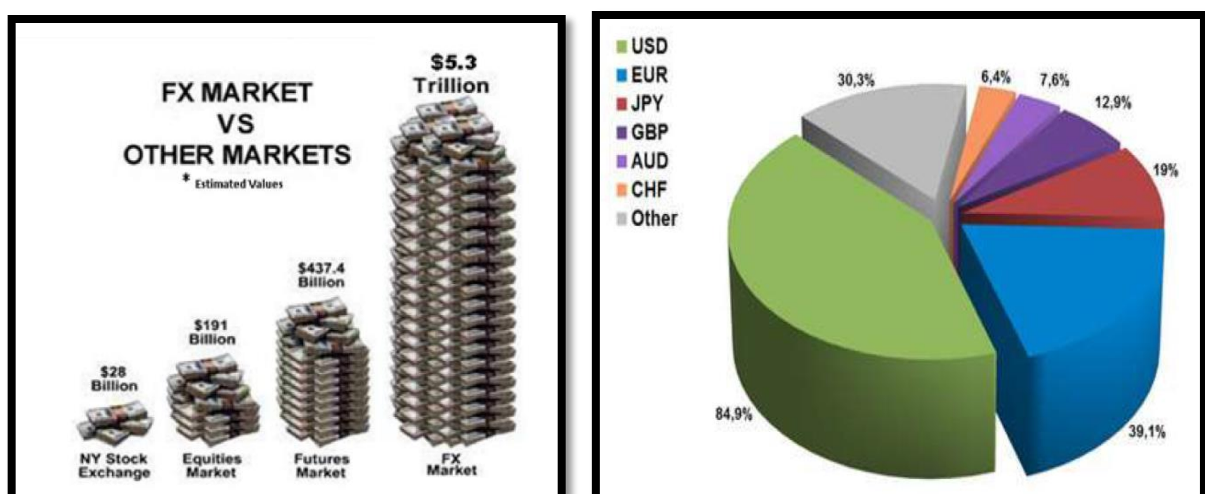

Figure 1

Source: Buckley (2012)

The largest traded currency is the US$, together with the Japanese Yen and the Euro, these three currencies dominate the market. Textbooks normally consider that organizations involved in commercial activities in Multiple Countries need to hedge this risk using internal or external techniques;

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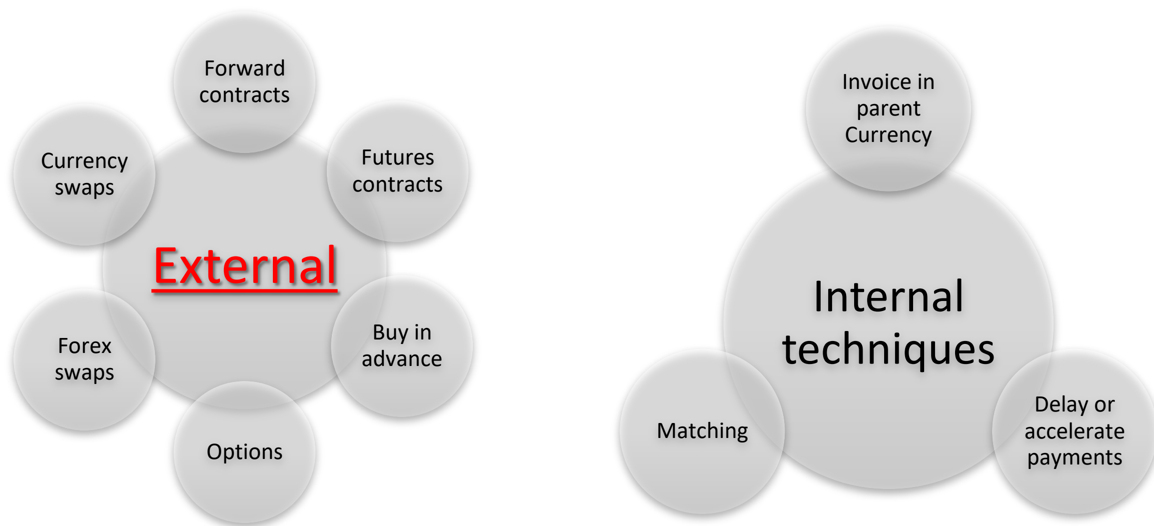

Figure 2

Source: Author

The justification for the need for these activities being due to loss of reported profits:

Exchange Rate Impacts on Operating Profits

Japanese Multinationals

- Sony, which generates more than 70 percent of revenue outside of Japan, says it loses about 2 billion yen of annual operating profit for each yen gain against the U.S. currency.
- Toyota notes that every one-yen gain in the Japanese currency against the dollar reduces Toyota's annual operating profit by 30 billion yen.

Figure 3

Source: Buckley (2012)

In fact the proposition that hedging is a necessary and common practice is enthusiastically proposed by the International Swaps and derivatives Association (2009). Stating in their research that 94% of global Fortune 500 Companies use some form of derivative based external hedging. ISDA (2009). Faff and Marshal (2005) do however note in their research published in the Journal of International business studies that Asia appears to be an exception to this, and that Asian Companies generally do not act to hedge. In the words of the research " it has a negative role for Asia Pacific MNC's". So why do Asia Pacific MNC's feel less inclined to use hedging?.

2. WHY SONY DOES NOT NEED TO HEDGE

A large Corporation like Sony has major operations located within the three large currency markets, Japan, Europe, and the USA. It also has its world wide Camera manufacturing located in Ayuthaya Thailand. Surely Sony needs to cover the exchange risk involved in dealing in these multiple currencies?

In fact it does not.

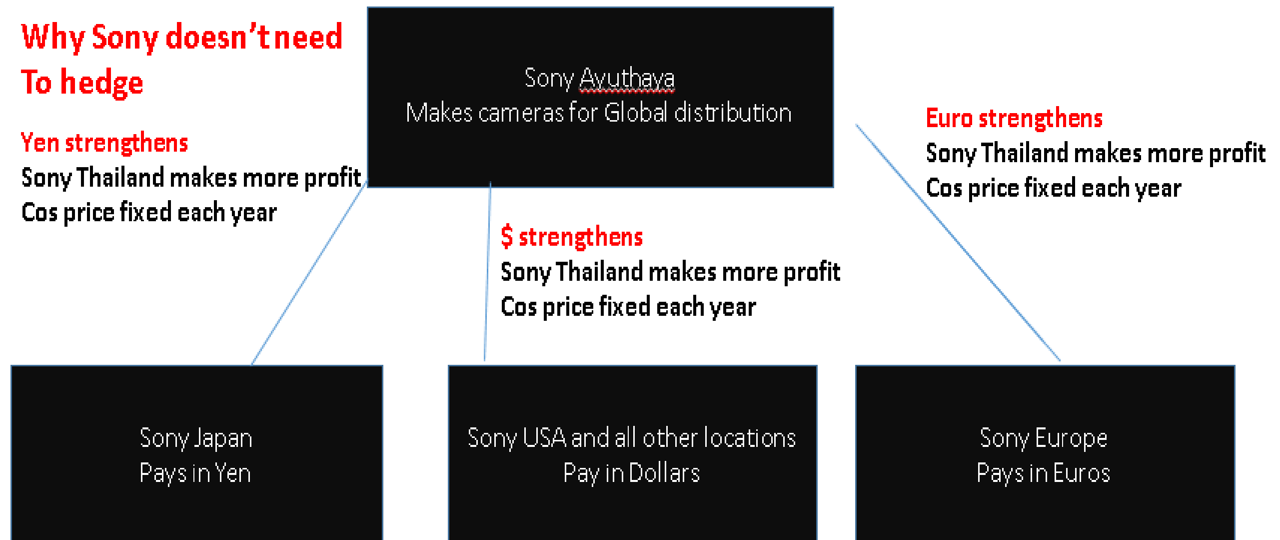

Figure 4

Source: Author

If we take one product, Cameras. Sony will internally sell its cameras from Thailand to Sony Japan, New York and Barcelona, each year, with the price being fixed at the beginning of the year. According to research commissioned by ASEAN and undertaken by Mae Fah Luang University Singapore (2010) less that 7% of exports from Thailand are in Thai Baht, the major export transaction currency is the US$. So The Bangkok plant incurs manufacturing costs in Thai Baht but earns income mainly in US $, or Japanese yen, or Euros, some components imported from Japan may also incur yen costs. If these currencies weaken Sony Thailand will report a drop in reported profits in Ayuthaya, however this is offset by a saving within the group of not having lost reported profits in Japan, the USA and Europe, as, although their currency has reduced in value they have not had to pay more for their camera's. The reverse would be the case if Sony changes strategy and exported using the Thai baht as its currency. Reported profits would go up in Thailand but drop in the three other locations in an equal amount.

By having large operations within the world's three major currency locations an Organization like Sony has an automatic hedge inbuilt into it's operations and does not need to be active in the derivatives market.

So what of the reported losses in figure 3 above. It is important to understand that these are not real losses. These are just reported profits, it is an accounting figure. No money has been lost outside of the group and assuming no transfer of surplus cash takes place the effect upon the company in real terms is zero.

Nissan demonstrated this in when they announced that although reported profits were down 12% in Yen terms (due to currency values) they were still on a growth track because sales volumes were increasing and that the reported profit figure was solely a product of currency fluctuation which did not effect them in real terms (Bangkok Post Nov 11th 2016)

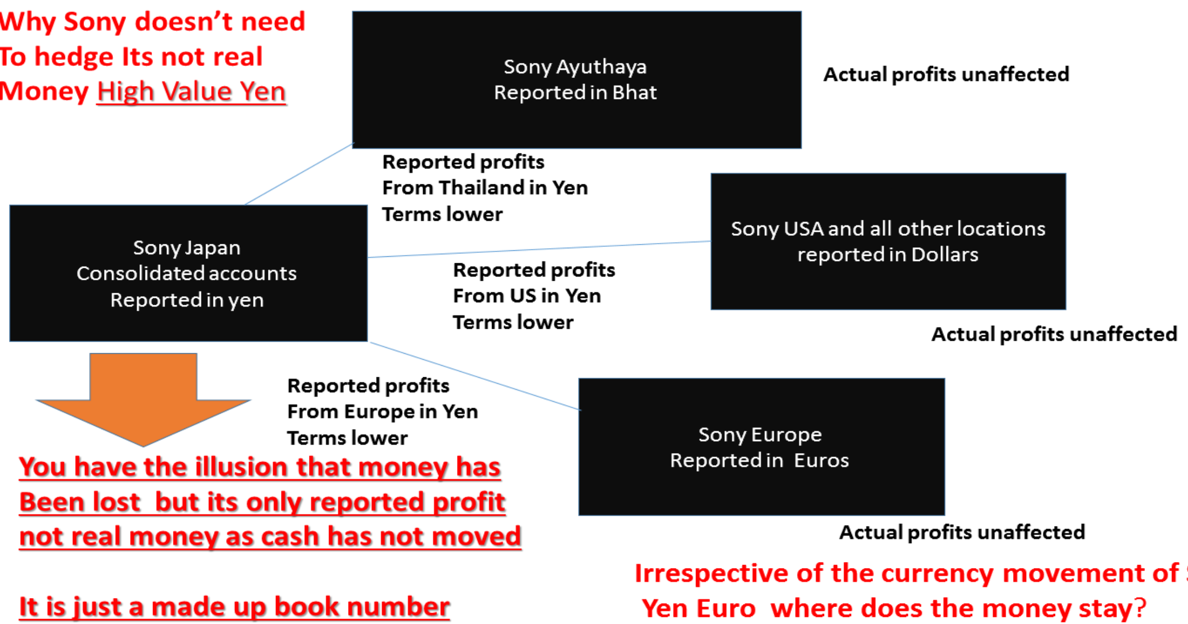

Figure 5

Source: Author

3. CONCLUSIONS

International finance textbooks quite rightly cover the theory of internal and external currency hedging , and some also cover multi national netting arrangements where overseas subsidiaries can offset currency risk internally against other subsidiaries located in other currency jurisdictions . Many textbooks, however, give the impression that hedging is vital for large MNC's. when in fact the reverse is the truth. This fundamentally comes from an unrealistic level of confidence placed on reported profit figures which it can be argued are inherently inaccurate in themselves due to estimates and assumptions made as part of the accounting and auditing process (a topic for another discussion). If you then combine this with the natural hedge MNC's have from having major operations in each major currency market, hedging becomes redundant. The Author would argue that the main participants in the derivatives currency market are in fact the financial institutions themselves. The most useful function that the market has for the real world is on the spot currency transactions;

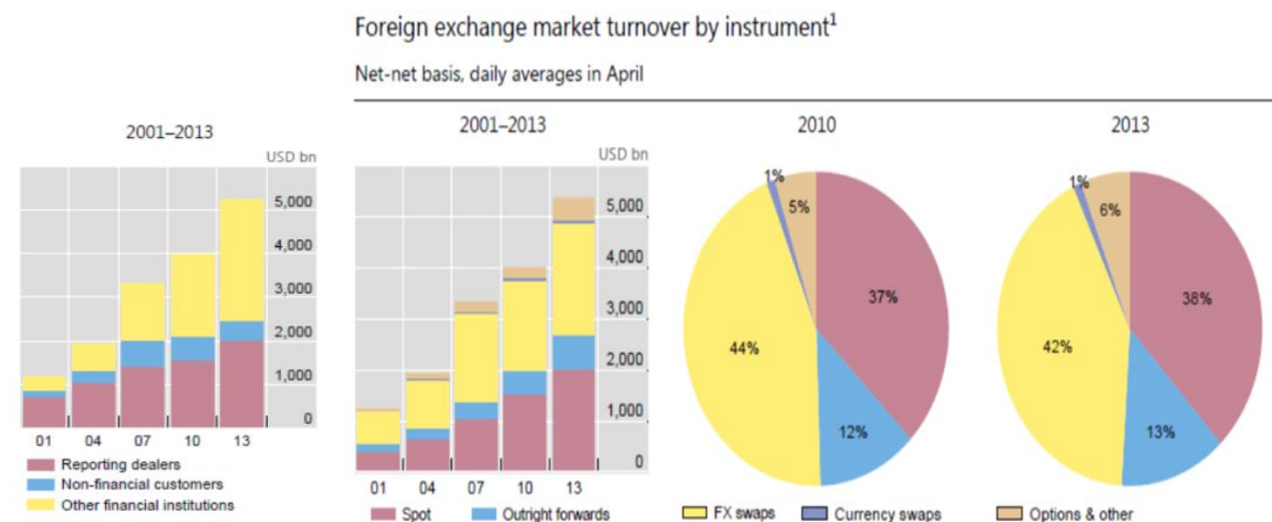

Figure 6

Source: Buckley (2012)

As can be seen above, a very small amount of the trading is done by non financial Institutions most of the trading is not within derivatives but is to cover immediate currency needs or very long term positions.

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