Advantages and disadvantages of a multinational corporation finance essay

The entities which are operating in more than one country are called Multinational Corporations. The typical Multinational Corporation functions with a headquarter in one country while other facilities are based in other countries. Multinational Corporation is also referred to transnational corporation. The model of the Multinational Corporation may vary but its simplest form is one that is headquarter in one country and its working units in other countries. Its main reason is that companies take advantage of reducing cost for the production of goods and also for the services.

It's another form is that all main functions are performed in the origin country of parent company and subsidiaries are less function independently. The start of such kind of business is traced is very old near about 17th century but in the 21st century. Multinational Corporation also comes in existence due to merger of different companies in different countries.

Advantages of Multinational Corporation:

There are many different reasons why a company practices as a Multinational Corporation. These reasons are given below:

Multinational companies can avoid or reduce their transportation cost.

Economies of scale also can be achieved.

Multinational companies have less chance of bankruptcy than small or non-multinational companies.

Research and development process is also more in practice.

Wage level in different countries is different, which is a major advantage.

Due to globalization, different markets are available.

Currency Fluctuations:

Currency fluctuation is referred to the changes of a relative value in one currency when compared to other country. The process of currency fluctuation is occurring every day which brings changes in rate of exchange of different currencies of different countries. It is the currency fluctuation which attracts is investors to invest in different currencies for gaining the profit. There are upward or downward movement in the currencies that refers to appreciate or depreciate of currencies. If an investor invests in a currency if that currency depreciates in accordance to investors own currency then there is a profit while if that currency appreciates in accordance of the investors own currency then there is a loss. Political issues may cause the currency fluctuation. If there are political issues of currency fluctuation there will be short term impact also it may be long term.

What is FOREX (Foreign Exchange)?

Foreign exchange is trading of one type of currency for another. Foreign exchange has no physical location and no central exchange like other financial markets. It operates through a global network of banks, corporations and individuals trading one currency for another. The foreign exchange market is the world's largest financial market which works 24 hours in a day which trades a huge amount of currencies of different countries. Not like any other financial market, investors can counter to currency fluctuations caused by economic, political and social events at the time when they occur, without having to wait for exchanges to open. The currency markets are not new that they have been around for as long as banks have been established for the dealing and transactions of money. What is relatively new is the openness of these markets to the individual investor, mainly the small- to medium-sized trader.

A Short History of the Foreign Exchange Trading Market:

Foreign exchange markets mainly established to make easy cross border trade in which there is involvement of different currencies by governments, companies and individual investors. More ever these markets generally existed to supply for the international movement of capital and money, even the initial markets had speculators. Today, a great part of Foreign Exchange market working is being determined by assumption, arbitrage and professional dealing, in which currencies are traded like any other commodity. The Retail Investors only means of gaining contact to the foreign exchange market was through banks that transacted in a huge amount of currencies for commercial and speculation purposes. After exchange rates were allowed to float freely in 1971, the volume of trade has been increased over the time. Most of the world’s major currencies were pegged to the US dollar due to an agreement that is called the Britton Woods Agreement. The participating countries try to maintain the value of their currencies against US Dollar also with the rate of the gold. These countries are bounded to devalue their currencies for the purpose of gaining advantage.

Types of markets and transactions:

There are two types of markets or transaction which are very common.

Spot market / spot transaction

Forward market / forward transactions

In spot transactions, buying and selling certain amount of foreign currency are based on current market rate and settlement are made and paid for without more ado. On the other hand, Forward transactions, are deals arranged for future settlement, to be paid for on decided dates on or after delivery.

Characteristics of Foreign Exchange Market:

There are some characteristics of Foreign Exchange Markets such as:

Volume of trading is very huge.

By the use of technologies like internet the foreign exchange trading centers are linked together to get updated information and for the trading.

Due to the integration of trading centers there is no significant arbitrage.

Functions of Foreign Exchange Markets:

What kind of functions of Foreign Exchange Market performs are give below:

Transfer of purchasing power.

Financing of inventory in transit.

Hedging.

Conversion of currencies.

Reducing of foreign exchange risks.

Participants of the Foreign Exchange Market:

There are the participants of the Foreign Exchange Markets those participates in dealing and transactions.

Banks & Foreign Exchange Dealers.

Individuals & Firms.

Speculators & Arbitrageurs.

Central Banks & Treasuries.

Foreign Exchange Brokers.

Foreign Exchange Transactions Advantages:

The advantages of the foreign exchange transactions are such as:

Commission Free Transaction

Direct Transactions

Round the Clock Market

Leverage (huge investment refers to huge profit)

Highly Liquid

Free online information

Foreign Exchange Transactions Disadvantages:

There are some disadvantages of foreign exchange transactions such as:

Leverage (huge investment refers to great loss)

Brokers (inexperienced, unfaithful)

Spreads (broker generally quote a fixed spread)

Role of Foreign Exchange Markets in the Global Market Place:

Exchange rate

Foreign currency denominated financial instrument

Exchange rate is referred to that how much units of one currency are required to purchase the one unit of other currency and foreign exchange denominated financial instrument is referred to bond, stock or a bank deposit whose value is denominated in the currency of another country. When you carry out business in a foreign country, you will have to exchange currencies involved at some existing exchange rate. The price of one country’s currency in terms of another country is called the exchange rate. When the currency of one country drops in value there will be an equivalent appreciation of value in another country’s currency. Depreciation (devalue of currency) occurs when it takes more currency to purchase the currency of another country. Appreciation (increase in value of currency) is just the opposite; the currency is able to purchase more units of the other country’s currency. Since most currencies are esteemed according to the market, usually there are constant changes to exchange rates.

Foreign Exchange Risks:

Foreign exchange risk is usually defined as Multinational Corporation faces variability in their currency values of assets, liabilities and operating income due to the unexpected currency fluctuation. That variability can be reduce or eliminate partially or fully.

Classification of Exposures:

There we can classify the Foreign Exchange Exposures in three types such as:

Transaction exposures

Translation exposures

Economic exposures

All these exposures severally affect the outcome of the business. How these exposures affect a business now we see individually all these exposures.

Transaction Exposure:

Transaction risk occur when any company makes trade, borrows, lend and sell the fixed assets of its subsidiaries company; all these operations takes lot of time so during that time when times come for the payment then there is real change of exchange rate so it refers to the Transaction Exposure.

Let see an example, a Pakistani importer make a deal for the some kind of commodity with United States suppliers after the delivery when time comes for payment if the importer pays in local currency (PKR) then the United

States supplies is at risk, if the payment is in foreign currency (USD) then the importer is at risk. Usually in this case exporter is at risk of exchange rate risk because supplier quotes the price in buyer's currency.

Translation Exposure:

Translation risk have to face when a parent company making its financial statements in its local currency. Because when consolidating the earnings, liabilities and assets of the subsidiaries company to the local currency then the exchange rate has changed, due to this exchange rate change the value of that asset when acquired has changed same to liability and earnings. Financial statements have to make in a single local currency for the stakeholders. Subsidiaries companies' value (assets, liabilities, earnings) is shown in financial statements in local currencies at current exchange rate.

Translation exposure depends upon the translation method. There are two common methods are used for the translation such as:

Current / non-current method

Monetary / non-monetary method

In current / non-current method current assets and liabilities are translated at current rate (closing rate at the time of making balance sheet), while non-current assets and liabilities are translated at the historical rates (the rate when asset was acquired and the liability incurred). According to this method only current assets and liabilities are exposed to currency fluctuation.

In monetary / non-monetary method the monetary assets and liabilities are translated at the current rate while the non-monetary assets an liabilities are translated at the historical rate. In this method monetary assets and liabilities are exposed to currency fluctuation.

Economic Exposure:

The change in the present value of a company due to change in future cash flows which caused by the fluctuation of the exchange rates. Cash flows can be classified in to two types like cash flows due to contractual commitment and the cash flows due to anticipated future transactions. Every transaction exposure is included in the economic exposure.

Let see an example, when the cost of a Multinational Company incurs in one currency and its sales generated in other currency so, the competitive advantage of the Multinational Company is affected by the change in exchange rate. Simply profit of the Multinational Company can decrease if the cost currency appreciates and