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A Study on Forex Risk Management Strategies in Blantyre and Lilongwe: Major Urban Centers of Malawi

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ABSTRACT

Amid acute foreign currency shortages, worsened by reduced exports and global supply chain disruptions due to COVID-19 and the Ukraine conflict, Malawi faces a challenging economic situation.

To stabilize decreasing forex reserves, the central bank devalued the kwacha by 25 percent in May and further by 44 percent recently. Despite these measures, the economy struggles with high inflation, escalating debt repayment obligations, and import cover sufficient for only about one month's worth of imports.

In this challenging economic landscape, prices for essentials like maize have surged by 15 percent, pushing the cost of living beyond the reach of many. The country's heavy reliance on agriculture, particularly tobacco exports, has proven insufficient to cover import bills, leaving a significant forex deficit. As a predominantly exporting nation, Malawi aims for a strong exchange rate to make goods affordable, but the ongoing forex scarcity has led to repeated devaluations, worsening the cost of living for the most vulnerable segments of society.

In response to this environment, this study embarked on a comprehensive examination of forex risk management strategies employed by businesses in Blantyre and Lilongwe. Employing a carefully designed cross-sectional research design, the study delved into the impact of forex scarcity on businesses' financial performance and operational dynamics. It evaluated the strategies deployed by businesses, ranging from hedging and diversification to forward contracts, providing insights into their efficacy amid the economic milieu. The findings highlighted both the resilience demonstrated by some businesses and the challenges posed by implementation hurdles and regulatory constraints.

Furthermore, the study uncovered a forward-looking approach embraced by businesses, characterized by a focus on sustainable practices and integration of advanced technologies to fortify forex risk management. However, it also revealed a gap in localized risk management solutions tailored to the unique Malawian context, calling for education initiatives, streamlined regulations, and support for private sector growth.

By contributing to the broader discourse on international finance and risk management, this research offers recommendations to empower businesses and policymakers in Blantyre, Lilongwe, and beyond. Fostering collaborative efforts, promoting investment in key sectors, and championing import substitution and forex generation emerge as critical strategies to chart a resilient course toward sustainable growth. The failure to address these challenges risks further economic deterioration and heightened adversity for Malawi's citizens, emphasizing the urgency of concerted action.

1. INTRODUCTION

This study delves into the complexities of Forex Risk Management Strategies employed by businesses in Blantyre and Lilongwe, the major urban centers of Malawi. It aims to investigate the challenges faced by businesses in navigating the volatile foreign exchange landscape and to identify sustainable strategies for mitigating forex risks.

2. LITERATURE REVIEW

Foreign currency exchange (Forex or FX) refers to a situation where one currency is converted or exchanged for another currency at a foreign exchange rate. The rate for conversion keeps on floating due to the dynamic of market forces of demand and supply. The foreign exchange market facilitates the exchange of all currencies over-the-counter market where trade occurs. It has become the largest with high trading volume and the it is the most liquid market in the world.

Brucaite and Yan 2000 define exchange rate risk as the magnitude and likelihood of unanticipated changes in exchange rate. Basically, the increased volatility of international markets generates increased financial risk to the companies. Exchange rate change is one of the financial risks where the increased volatility is reflected to the greatest extent. Jacques (1981) defines foreign exchange risk as the risk that an entity will be required to pay more (or less) or receive less (or more) than expected as a result of fluctuations in the exchange rate between its currency and the foreign currency in which payment must be made. Foreign exchange risk is the additional variability experienced by a firm in its worldwide consolidated earnings that results from unexpected currency fluctuations. According to Glaum (2000), firms are exposed to foreign exchange risk if the results of their projects depend on future exchange rates and if exchange rate changes cannot be fully anticipated.

Li (2003) observes that exchange rates have been volatile ever since the breakdown of the Bretton Woods system of fixed exchange rates in the early 1970s. Occasional exchange rate crises have also led to sudden and significant exchange rate changes. Li (2003) states that there have also been major changes in exchange rates as the result of shifts in monetary policies. Firms have therefore had to come to terms with ever-present and sometimes very significant exchange rate risk.

Train (1986) asserts that the foreign exchange market is the mechanism by which a person or firm transfers purchasing power from one country to another, obtains or provides credit for international trade transactions or minimizes exposure to the risks of changing foreign exchange rates. The foreign exchange market connects short-term capital markets in several nations in addition to international currency flows. Since parties engaged in international trade and capital transactions typically reside in nations with distinct national currencies, the foreign exchange market serves as a means of transferring purchasing power. Through specialized instruments like banker's acceptances and letters of credit, it offers a third source of credit that can be used to finance foreign trade.

Historically, the exchange rate policies of Malawi have typically involved being tied to either a single currency or a basket several currencies. The nominal exchange rate has traditionally been tightly regulated by the government, which uses it as a tool to encourage growth and safeguard investors' and consumers' money against inflation. On the one hand, the Malawian economy is heavily reliant on imports, therefore devaluation affects consumers by raising domestic import prices. In addition, the economy is heavily reliant on agriculture, which accounts for about one-third of GDP and generates more than 80% of export revenues. Malawian agriculture is primarily rainfed, hence growth in the industry is erratic. When the currency rate is overvalued, agricultural exports are curtailed, causing agricultural and national growth to decline.

In this context, Cammack (2011) emphasized the significance of effectively managing the exchange rate to foster sustainable economic growth in Malawi. Lea and Hanmer (2009) supported this viewpoint, highlighting the substantial sensitivity of Malawi's GDP to export revenues denominated in local currency terms, suggesting that adept exchange rate management could yield considerable benefits to incomes, potentially outweighing the impact of other policy tools. Drawing from comprehensive cross-country analyses, Rodrik (2008) contended that developing nations should strive to maintain a deliberately undervalued currency, positing that this approach fosters enduring economic growth. Rodrik and colleagues further noted that an overvalued exchange rate is linked to various challenges, including foreign exchange scarcities, instances of rent-seeking and corruption, sizable current account deficits, pressures on the balance of payments, and erratic macroeconomic cycles, all of which can undermine long-term economic prosperity.

3. RESEARCH METHODOLOGY

The research methodology employed in this study involved adopting a cross-sectional design to capture a comprehensive snapshot of forex risk management practices among businesses operating in the major urban centers of Blantyre and Lilongwe, situated in Malawi. These cities, renowned for their economic significance, serve as focal points for various commercial activities, ranging from finance and manufacturing to trade and services. To ensure the study's robustness and representativeness, a stratified random sampling technique was implemented, dividing the target population into distinct strata based on industry and size categories. From this stratification, a total of 20 businesses were sampled, with 10 each selected from Blantyre and Lilongwe, thus offering a balanced representation across different urban settings. Primary data collection was conducted through the dissemination of structured questionnaires directly to participants, facilitating the acquisition of firsthand insights into forex risk management strategies and challenges faced by businesses in the specified regions. Concurrently, secondary data sources, including academic literature, reports, and case studies, were leveraged to provide a broader contextual understanding of forex scarcity and risk management practices. The utilization of both primary and secondary data sources enabled researchers to achieve a comprehensive exploration of the subject matter, thereby enhancing the validity and reliability of the study findings. The structured questionnaire, employed as the primary data collection tool, was distributed through both physical and online channels, ensuring accessibility and convenience for participants. Statistical analysis of the collected data was conducted using the Statistical Package for the Social Sciences (SPSS), while Microsoft Excel was utilized for data visualization purposes. By employing this methodological framework, the study aimed to shed light on the intricate dynamics of forex risk management within the urban business landscape of Malawi, thereby contributing valuable insights to the existing body of knowledge in this field.

4. RESULTS OF THE STUDY

Out of 20 businesses approached, 15 participated in the study, providing valuable insights into forex risk management practices and challenges encountered in Blantyre and Lilongwe. The findings reveal significant insights into the impact of forex constraints over the past year, with a majority of respondents experiencing significant (40%) or slight (46.67%) negative effects. Transaction risk (53.33%) and translation risk (46.67%) emerged as the most prevalent forex risks, highlighting concerns about exchange rate fluctuations and their impact on financial statements. Despite these challenges, the adoption of specific forex risk management strategies varied, with diversification (33.33%) and options (13.33%) being among the approaches employed. However, over half of the businesses (53.33%) reported not employing any specific strategy, indicating a potential gap in formalized risk management practices. The integration of technology in risk management was limited, with a significant portion of businesses either not using technology at all (33.33%) or only leveraging it rarely (33.33%). Challenges in implementing risk management strategies included a lack of expertise (53.33%) and regulatory barriers (40%), highlighting the need for specialized knowledge and navigating complex regulatory environments. Despite these challenges, the majority of businesses (87.67%) expressed plans to adjust or implement new risk management strategies in the next 12 months, driven by factors such as anticipation of currency devaluation (64.29%) and economic forecasts (57.14%). Additionally, there was a notable interest in integrating more advanced technologies (73.33%) to enhance risk management capabilities, underscoring a shift towards modernization in risk management practices. Businesses primarily relied on online forums and communities (60%) for staying informed about industry trends and best practices, indicating a preference for digital platforms in accessing timely information. However, the use of technology and data analytic tools for enhancing risk management was only moderately common (40%), suggesting room for further adoption and integration of technological solutions.

5. DISCUSSIONS

The first objective was to evaluate the impact of current forex scarcity on businesses in Blantyre and Lilongwe, Malawi. The findings revealed a multifaceted impact on businesses' financial performance and operational dynamics. Firstly, businesses reported varying degrees of negative impact, with some experiencing significant setbacks while others faced relatively minor disruptions. Factors contributing to this impact included limited access to foreign currency, exchange rate fluctuations, regulatory constraints, and trade barriers. These challenges manifested in decreased profitability, increased costs of imports, and disruptions in supply chains, adversely affecting businesses' competitiveness and financial stability. Additionally, the study highlighted the resilience of some businesses, showcasing adaptive measures such as diversification of revenue streams and operational strategies to mitigate the effects of forex scarcity. However, despite these adaptive measures, the overall consensus pointed to a challenging economic environment characterized by uncertainty and volatility. In conclusion, the evaluation underscores the significant challenges posed by forex scarcity on businesses in Blantyre and Lilongwe, emphasizing the need for proactive measures and policy interventions to foster economic resilience and sustainability in the face of ongoing forex constraints.

The second objective was to identify sustainable forex risk management strategies adopted by businesses in Blantyre and Lilongwe, Malawi, in response to increased forex scarcity during current economic conditions.

A subset of businesses reported employing hedging as a forex risk management strategy. Hedging involves the use of financial instruments to offset potential losses due to exchange rate fluctuations. The limited adoption of hedging suggests that businesses may not fully leverage financial instruments for risk mitigation.

Furthermore, a notable proportion of businesses embraced diversification as a strategy. Diversification entails spreading business activities or investments to mitigate the impact of forex risk across different areas. Diversification emerges as a popular strategy, indicating businesses' recognition of the importance of spreading risk.

In addition, a smaller percentage of businesses mentioned using forward contracts. This strategy allows businesses to lock in a future exchange rate, providing a level of certainty in currency transactions. The modest use of forward contracts suggests a nuanced approach to locking in future exchange rates.

On the other hand, a significant percentage of businesses noted not employing any specific forex risk management strategy, indicating a varied landscape where some businesses may rely on adaptability rather than structured strategies.

The third objective was to assess the efficiency of current forex risk management strategies employed by businesses in Blantyre and Lilongwe. The findings revealed a mixed landscape, with businesses employing various strategies to mitigate forex risk. Through a combination of hedging, diversification, forward contracts, and options, businesses aimed to offset potential losses arising from exchange rate fluctuations and limited access to foreign currency. However, the effectiveness of these strategies varied, with some businesses perceiving their approaches as moderately effective while others faced challenges in implementation and regulatory barriers. Despite the diverse range of strategies employed, the study highlighted the need for continuous evaluation and adaptation to navigate the evolving economic conditions effectively.

Finally, the fourth objective aimed to explore sustainable forex risk management practices employed by businesses in Blantyre and Lilongwe, Malawi. The findings indicated a forward-looking approach among businesses, with a focus on future adaptations and the adoption of new strategies. Businesses demonstrated an awareness of key factors influencing their decisions, such as anticipation of currency devaluation, market competition, regulatory changes, and economic forecasts. This proactive stance reflects a recognition of the importance of staying ahead of the curve in a dynamic economic environment.

Moreover, the willingness of businesses to integrate advanced technologies into their forex risk management practices signals an acknowledgment of the potential benefits offered by technological advancements. By leveraging these tools, businesses aim to enhance their risk management strategies and adapt to the evolving forex landscape effectively. This forward-looking perspective underscores a commitment to resilience and sustainability, as businesses seek to navigate the challenges posed by forex scarcity and exchange rate fluctuations.

6. RECOMMENDATIONS

A tailored education and training program should be developed to address the knowledge gap among businesses regarding forex risk management. Using these programs, businesses can learn about risk management through practical workshops and seminars. Providing businesses with the necessary skills and knowledge will enable them to mitigate forex risks effectively.

The second recommendation is that policymakers simplify regulations and improve access to hedging instruments to assist businesses in managing forex risks. Businesses would be able to protect themselves against currency fluctuations and regulatory barriers if bureaucratic processes were streamlined. Additionally, improving access to hedging instruments would enable businesses to hedge their forex exposures more effectively, enhancing their resilience in volatile market conditions.

Thirdly, businesses should be encouraged to embrace technology as a tool for forex risk management. Digital solutions can simplify risk assessment and decision-making processes, providing businesses with real-time insights into market trends and currency movements. By integrating technology into their operations, businesses can streamline their forex risk management practices and make more informed strategic decisions.

Fourthly, fostering collaboration within industries can strengthen businesses' resilience to forex risks. By sharing best practices and resources, businesses can collectively navigate the challenges posed by currency fluctuations and regulatory constraints. Collaborative efforts can lead to the development of innovative solutions and strategies that benefit the entire industry ecosystem.

Fifthly, government initiatives should prioritize stabilizing the exchange rate and ensuring adequate forex liquidity to support businesses. By implementing policies that promote currency stability and liquidity, governments can create a conducive environment for businesses to operate and thrive. Such initiatives would provide businesses with the stability and confidence they need to invest and grow their operations.

Sixthly, capacity-building programs should offer practical, hands-on training to equip businesses with the tools and knowledge they need to implement effective forex risk management strategies. These programs should focus on practical skills and real-world scenarios, empowering businesses to proactively manage their forex exposures and navigate market uncertainties with confidence.

Lastly, fostering a culture of continuous improvement is essential for businesses to adapt and thrive in the ever-evolving forex market. By encouraging a mindset of learning and adaptation, businesses can continuously refine their risk management strategies and stay ahead of emerging threats and challenges. This commitment to continuous improvement will enable businesses to build resilience and sustain long-term success in the face of forex risks.

7. CONCLUSION

In conclusion, this study emphasizes the critical need for robust forex risk management strategies among businesses in Blantyre and Lilongwe, especially given the challenging economic environment. Through a thorough examination of current practices and challenges, important insights have been uncovered. It's clear that businesses face significant barriers, such as limited access to foreign currency and complex regulations. However, there are opportunities for improvement. By embracing targeted education programs and using technology effectively, businesses can strengthen their risk management efforts. Collaboration and a commitment to continuous improvement are essential for navigating the complexities of the forex market. This study not only diagnoses the current situation but also calls for collective action to promote resilience and sustainable economic development in Malawi's urban areas.

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