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Offshore Activities and Financial vs Operational Hedging

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ABSTRACT

A key question is why many multinational firms forgo foreign exchange derivative (FX) hedging and instead use operational hedging. We propose an explanation based on illiquidity and the unique advantages of operational hedges. We use 10-K filings to construct dynamically updated text-based measures of the offshore sale of output, purchase of input, and ownership of assets. We find that firms use FX derivatives when they are liquid and generally available. Otherwise, they often favor purchasing input from the same nations they sell output to, an operational hedge. Quasi-natural experiments based on new derivative product launches suggest a likely causal relation.

JEL classification: F14, F23, G15, G32
Keywords: Offshore operations, Operational hedging, Financial hedging, Risk management, 10-K filings

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