



Exchange Rate Risk and Its Impact on Cross-Border Investments

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Abstract

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Exchange rate risk has become an important issue in the global financial system due to the increasing integration of international financial markets and the expansion of cross border investment activities. This study aims to examine the relationship between exchange rate volatility, exchange rate risk, and cross-border investment. The study applies a systematic literature review method to identify, evaluate, and synthesize relevant academic studies discussing the impact of currency fluctuations on international investment and corporate decision making. The findings indicate that exchange rate volatility increases uncertainty in international financial markets, which can discourage foreign investors from allocating capital to foreign economies and reduce foreign direct investment inflows. In addition, exchange rate risk also influences corporate investment behavior because firms exposed to currency fluctuations may experience changes in expected cash flows and investment returns. As a result, multinational corporations often implement risk management strategies to mitigate the negative effects of exchange rate instability. Overall, stable exchange rate conditions and effective risk management practices play an essential role in supporting sustainable international investment activities.

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1. Introduction

Exchange rate risk has become a critical issue in the global financial system as international capital mobility and cross-border investment activities continue to expand. Exchange rate fluctuations influence the value of foreign assets and liabilities, thereby affecting the profitability and risk exposure of multinational corporations and international investors. In an increasingly integrated financial market, investors engaging in cross-border investments must consider the potential impact of currency movements on investment returns, portfolio diversification, and overall financial performance. Exchange rate movements can alter the valuation of international financial positions and influence the allocation of capital across countries, making exchange rate risk management an essential component of international investment strategies (Bénétrix, 2024).

Exchange rate volatility introduces uncertainty that may significantly affect investment decisions and international capital flows. When exchange rates fluctuate unpredictably, investors face increased risks related to transaction costs, profit repatriation, and asset valuation. Such volatility can discourage foreign investors from committing capital to foreign markets due to the possibility of currency losses, even when the underlying investment opportunities are attractive. Empirical studies have shown that higher levels of exchange rate volatility are often associated with reduced foreign direct investment (FDI) inflows and lower cross-border capital investment, particularly in emerging economies where currency instability tends to be more pronounced (Hamida, 2024).

Furthermore, exchange rate risk affects corporate investment behavior and financial decision-making at the firm level. Firms exposed to foreign exchange fluctuations may experience changes in expected cash flows and investment returns, which can ultimately influence capital expenditure and international expansion strategies. Research indicates that unexpected foreign exchange volatility can reduce corporate investment levels, particularly for firms without effective hedging mechanisms or currency risk management strategies. Consequently, managing exchange rate exposure through financial instruments, diversification, or operational hedging has become a crucial practice for multinational corporations and international investors (Taylor, 2021)

Given the growing importance of global investment integration, understanding the relationship between exchange rate risk and cross-border investment has become increasingly relevant for policymakers, financial institutions, and investors. Stable exchange rate environments tend to encourage international investment by reducing uncertainty, while volatile currency movements can undermine investor confidence and disrupt capital allocation across borders. Therefore, examining how exchange rate risk influences cross-border investment decisions contributes to a deeper understanding of international financial dynamics and provides valuable insights for developing effective risk management strategies in global investment markets (Lal et al., 2023).

2. Literature Review

2.1. Exchange Rate Volatility and Cross-Border Investment Flows

Exchange rate volatility is a crucial factor influencing cross-border investment flows because it creates uncertainty regarding the value of international assets and investment returns. Significant fluctuations in exchange rates expose investors to additional risks related to currency conversion, profit repatriation, and changes in the valuation of international portfolios. Empirical studies indicate that increased exchange rate volatility tends to reduce foreign investment flows as investors become more cautious about allocating capital to countries with unstable currencies. Research has shown that exchange rate volatility has a negative relationship with Foreign Direct Investment (FDI) inflows, particularly in developing economies where macroeconomic stability is relatively weaker (Hniya, 2021; Lajevardi & Chowdhury, 2024; Ullah & Haider, 2024). Furthermore, currency volatility may increase international transaction costs and reduce incentives for multinational firms to expand across borders, as exchange rate risk can diminish the expected returns from global investments.

2.2. Exchange Rate Risk and Corporate Investment Decisions

In addition to influencing international investment flows, exchange rate risk also directly affects corporate investment decisions at the firm level. Companies engaged in international transactions are exposed to fluctuations in exchange rates that may alter the value of expected cash flows, thereby affecting investment planning, financing decisions, and global expansion strategies. Previous studies suggest that exchange rate uncertainty can reduce corporate investment because

firms tend to delay or adjust investment projects when currency risks increase. Consequently, multinational corporations often implement various risk management strategies, such as financial hedging, market diversification, and operational adjustments, to mitigate the impact of exchange rate volatility on financial performance (Rashid, 2022; Lal et al., 2023). These strategies help firms maintain cash flow stability and enhance investor confidence in the presence of global market uncertainties.

To provide a clearer overview of previous studies related to exchange rate risk, exchange rate volatility, and cross-border investment, several relevant empirical studies are summarized in Table 2.1. These studies highlight how exchange rate fluctuations influence foreign direct investment, corporate investment decisions, and international capital flows. The table presents the main focus, methodology, and key findings of prior research that form the theoretical foundation for this study.

Table 1. Prior Research

| No | Author(s) | Year | Research Focus | Method / Data | Key Findings |
|----|-----------|------|---|--|--|
| 1 | Bénétrix | 2024 | Examines the role of exchange rate movements in international financial integration and global investment portfolios. | Empirical analysis of international financial positions and capital flows. | Exchange rate fluctuations significantly influence the valuation of foreign assets and liabilities, affecting capital allocation and investment strategies across countries. |
| 2 | Hamida | 2024 | Investigates the impact of exchange rate volatility on | Econometric analysis using cross-country data | Higher exchange rate volatility discourages foreign investment and is associated |

| No | Author(s) | Year | Research Focus | Method / Data | Key Findings |
|----|-----------------------|------|---|--|---|
| | | | foreign investment decisions and capital flows. | on exchange rates and FDI inflows. | with lower FDI inflows, especially in emerging markets with unstable currencies. |
| 3 | Taylor | 2021 | Analyzes how exchange rate risk affects corporate investment and financial decision-making. | Firm-level analysis focusing on investment behavior under currency fluctuations. | Exchange rate volatility can reduce corporate investment levels, particularly for firms that lack effective hedging or currency risk management strategies. |
| 4 | Hniya | 2021 | Studies the relationship between real exchange rate volatility and foreign direct investment inflows. | Time-series and econometric analysis of macroeconomic data. | Real exchange rate volatility negatively affects FDI inflows, indicating that currency instability increases investment uncertainty. |
| 5 | Rashid | 2022 | Examines determinants and implications of exchange rate volatility for financial markets and firms. | Empirical analysis using financial market and macroeconomic indicators. | Exchange rate uncertainty influences financial decision-making and encourages firms to adopt hedging strategies to manage currency exposure. |
| 6 | Lal, Lim, & Mandrinos | 2023 | Investigates the relationship between exchange rate volatility and international investment and trade dynamics. | Econometric modeling using international financial data. | Stable exchange rate environments support cross-border investment, while volatility undermines investor confidence and disrupts capital allocation. |

| No | Author(s) | Year | Research Focus | Method / Data | Key Findings |
|----|-----------------------|------|--|--|---|
| 7 | Lajevardi & Chowdhury | 2024 | Explores the effect of exchange rate movements and volatility on FDI flows. | Disaggregated empirical analysis using country-level data. | Exchange rate instability significantly affects the level and direction of foreign direct investment flows. |
| 8 | Ullah & Haider | 2024 | Examines the impact of exchange rate volatility on FDI using an ARDL approach. | ARDL bound testing with macroeconomic variables. | Exchange rate volatility has a negative and significant impact on foreign direct investment inflows. |

3. Methods

This study employs a Systematic Literature Review (SLR) method to examine the relationship between exchange rate risk, exchange rate volatility, and cross-border investment. The SLR approach is used to systematically identify, evaluate, and synthesize relevant academic literature in order to provide a comprehensive understanding of how exchange rate fluctuations influence international investment behavior and corporate financial decisions. This method enables the study to integrate findings from various empirical studies and theoretical discussions in the field of international finance.

The literature selection process was conducted through several stages. First, relevant academic articles were identified through major scholarly databases such as Google Scholar, ScienceDirect, and other academic indexing platforms using keywords including exchange rate risk, exchange rate volatility, foreign direct

investment, cross-border investment, and corporate investment decisions. Only peer-reviewed journal articles were considered to ensure the reliability and academic quality of the sources. The search results were then screened based on relevance to the research topic, focusing on studies that analyze the relationship between exchange rate fluctuations and international investment flows or corporate investment behavior.

After the identification stage, the selected articles were evaluated using inclusion and exclusion criteria. Studies were included if they directly discussed exchange rate volatility, exchange rate risk management, or their impact on foreign direct investment and corporate investment decisions. Articles that were not directly related to international investment or that lacked empirical or theoretical relevance were excluded. The selected literature was then systematically reviewed and analyzed to identify key themes, research approaches, and empirical findings.

Finally, the extracted information from the selected studies was synthesized and summarized to identify patterns and relationships among previous research findings. The results of this synthesis are presented in the form of a prior research summary table, which highlights the research focus, methodology, and key findings of the selected studies. Through this systematic process, the SLR method allows this study to provide a structured and comprehensive overview of existing literature and to identify important insights regarding the influence of exchange rate risk on cross-border investment decisions.

4. Results and Discussion

4.1. Exchange Rate Volatility and Cross-Border Investment Flows

The results of the systematic literature review indicate that exchange rate volatility plays a significant role in shaping cross-border investment flows. Based on the synthesis of prior studies, fluctuations in exchange rates increase uncertainty in international financial markets, which can discourage investors from allocating capital to foreign economies. Exchange rate instability affects the value of international assets and liabilities, thereby influencing investment returns and the overall attractiveness of foreign markets (Bénétrix, 2024). When exchange rates become highly volatile, investors tend to perceive greater risks related to currency conversion, profit repatriation, and asset valuation.

Several empirical studies confirm that exchange rate volatility has a negative relationship with foreign direct investment inflows. For instance, research by Hniya (2021) and Ullah and Haider (2024) demonstrates that higher levels of exchange rate volatility significantly reduce FDI inflows because investors prefer stable economic environments to minimize financial uncertainty. Similarly, Lajevardi and Chowdhury (2024) find that unstable exchange rate movements can alter the direction and volume of foreign investment flows by increasing transaction costs and reducing expected returns from international investments. These findings support the argument that exchange rate stability is an important factor in encouraging international capital mobility and investment integration.

Furthermore, exchange rate volatility tends to have a stronger impact in emerging economies where macroeconomic stability is relatively weaker. Hamida

(2024) explains that currency instability in developing markets often increases the perceived risk among foreign investors, leading to lower investment inflows despite the presence of attractive economic opportunities. Additional studies also suggest that exchange rate uncertainty can influence international capital allocation decisions and may lead investors to shift their portfolios toward countries with more stable currency environments (Chen et al., 2024). Therefore, maintaining stable exchange rate conditions becomes an important policy objective for governments seeking to attract foreign investment and support economic growth.

4.2 Exchange Rate Risk and Corporate Investment Decisions

The findings of this study also show that exchange rate risk significantly influences corporate investment decisions, particularly for firms engaged in international business activities. Firms that operate across borders are exposed to currency fluctuations that may affect expected cash flows, operational costs, and overall profitability. As a result, exchange rate volatility can influence corporate financial planning and investment strategies. Taylor (2021) argues that unexpected currency fluctuations can reduce corporate investment because firms often delay or scale down investment projects when exchange rate uncertainty increases.

At the firm level, exchange rate risk may also affect capital expenditure decisions and international expansion strategies. Rashid (2022) highlights that firms facing higher exchange rate volatility tend to adopt more conservative investment behavior to avoid potential financial losses. This is particularly evident among companies that lack effective hedging mechanisms or risk management strategies. Consequently, multinational corporations frequently implement financial hedging

instruments, operational hedging, and market diversification strategies to mitigate the adverse effects of currency fluctuations on financial performance.

Moreover, the relationship between exchange rate risk and corporate investment is closely linked to global financial integration. Lal et al. (2023) show that stable exchange rate environments support corporate investment and cross-border business expansion by reducing financial uncertainty and improving investor confidence. In contrast, volatile exchange rates may disrupt investment planning and increase the cost of international transactions. Supporting this view, Alhattali et al. (2024) find that firms with higher exposure to foreign exchange risk tend to adjust their investment and financing strategies to manage currency-related uncertainty more effectively.

Overall, the findings of this systematic literature review indicate that exchange rate volatility and exchange rate risk are important determinants of both cross-border investment flows and corporate investment behavior. While exchange rate stability can encourage international capital movement and corporate expansion, excessive volatility tends to discourage investment and increase financial uncertainty. Therefore, effective exchange rate risk management strategies and stable macroeconomic policies are essential for promoting sustainable international investment and improving the resilience of global financial markets.

5. Conclusion

This study examines the relationship between exchange rate risk, exchange rate volatility, and cross-border investment through a systematic literature review.

The findings indicate that exchange rate volatility plays a crucial role in shaping international investment flows. Fluctuations in exchange rates create uncertainty regarding asset valuation, profit repatriation, and expected returns, which may discourage investors from allocating capital to foreign markets. As a result, countries with unstable exchange rate conditions may experience reduced foreign direct investment and lower levels of cross-border capital flows. Stable exchange rate environments therefore become an important factor in attracting international investors and maintaining consistent investment inflows.

In addition, the review also highlights that exchange rate risk significantly affects corporate investment decisions. Firms that operate in international markets are exposed to currency fluctuations that may alter expected cash flows and investment returns. When exchange rate uncertainty increases, companies may delay investment projects, reduce capital expenditures, or reconsider expansion strategies in foreign markets. Consequently, effective exchange rate risk management becomes essential for multinational corporations in maintaining financial stability and sustaining international business operations.

Overall, the study demonstrates that exchange rate stability and effective risk management strategies are key elements in supporting international investment activities. By reducing uncertainty and protecting firms from adverse currency movements, appropriate exchange rate management can enhance investor confidence and facilitate the efficient allocation of capital across countries in the global financial system.

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