

Question No.3 Define transaction exposure. How is it different from economic exposure? Discuss and compare transaction exposure using the forward market hedge and. money market hedge?

Solution: Foreign exchange rates are highly volatile. In a free market, changes occur practically every second. The movement in foreign exchange rates occurs as a result of genuine trade transactions in the case of highly regulated markets like the Indian market where speculation is strictly prohibited. Thus, export and import transactions or borrowings and lending in foreign currency move foreign exchange rates in India. The intraday trends may be more predictable than slightly longer-term trends; but the uncertainty does exist. And where there is a substantial time gap between the date of the contract and its maturity, the uncertainty can be quite fearsome. The time gap will depend on the credit period permissible for such transactions. At present, the Reserve Bank of India permits a credit period of up to six months for export and import transactions. Now, surely, 180 days is a long enough period for forecasts of movements in foreign exchange rates to be rendered imprecise. Hence, there arises a transaction exposure which needs to be measured and managed well in order to minimise its negative effect on corporate profitability or wealth. The treasury departments managing foreign exchange fluctuations are sometimes looked upon as profit centres – whereby, the main objective becomes that of making a profit out of foreign exchange movements. Yet, the primary aim remains that of avoiding the uncertainty relating to the future exchange rate that will prevail on the date the contract matures.

On the other hand, Economic exposure relates to ‘cash flow’ risks. The term cash flow has been defined in different ways. In sum, economic (competitiveness) risk is concerned with threats from changes in real exchange rates to the competitiveness of costs. The seriousness of the risk depends on how hard it is to shift costs between currencies. For example, the value added by the contractor for a petrochemical process plant is largely design and management, the hardware is all procured from manufacturers. The largest item, the compressor, can be ordered from manufacturers in a number of countries, and if a high real exchange rate makes the British compressor maker uncompetitive, then the contractor has little difficulty in switching this major cost item to a supplier with costs in a more competitive currency. Procurement costs are seldom locked into a particular currency, whereas labour and capital costs are not easily or rapidly switched. So, contractors are better placed than manufacturers to switch costs by switching subcontracts. If the main contractor had been a British compressor manufacturer, it would have found it much harder to purchase the compressor from its Swiss competitor, leaving its own British workforce to face redundancies.

Forward Market Hedge

The term hedging refers to mean a transaction undertaken specifically to offset some exposure out of the firm’s usual operations. A forward market hedge refers to a transaction specifically undertaken in the forward market. The transaction is normally a forward contract with an authorised dealer, i.e., one authorised to deal in foreign currency – that is, sell or purchase foreign currency. Most commercial banks have been

authorised to deal in foreign currency by the Reserve Bank of India. And so, a firm which is expecting a receivable or a payable sometime in the near future can enter into a

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forward contract with an authorised commercial bank to fix the rupee rate vis-a-vis the foreign currency in which the receivable or the payable will materialise. This effectively avoids the uncertainty of the future exchange rate; for whatever the rate prevailing at that time, the firm has locked in a rate for itself.

A forward contract cannot be entered into for an unlimited period. The maximum period was earlier directly related to the maximum credit period permissible, i.e., six months. Under the new RBI guidelines, the maximum period has now been extended to one year. A firm may, therefore, enter into a one-year forward contract or of any shorter duration.

It is typical in case of foreign currency loans wherein not only the principal amount but also the series of interest payments is likely to extend beyond a period of one year. In such a case, there is the facility of roll-over contracts. A roll-over contract is rolled over for the next desired period every time the maturity date arrives.

An option in the period of the contract may be desired when there is some uncertainty as regards the exact date of a receivable or payable. For example, the best a firm may know is that shipment will arrive anytime between the third and the sixth month of the date of the contract. Accordingly, payment is also due within the third and the sixth month. The firm, obviously, cannot enter into an outright forward contract for a fixed period. The firm, in such a case, can enter into an option forward contract. However, it must be remembered that an option forward contract proves to be quite expensive for the firm, as the authorised dealer will take the maximum benefit of the premium or discount for itself. One must remember that in all cases, the amount of the forward cover cannot exceed the value of the underlying commercial transaction. That is because no speculation is permissible under Indian laws. Another aspect relating to forward contracts is that although it does not offer any flexibility to the customer in terms of the rate (the contract with the authorised dealer must be honoured at the fixed rate), it offers the facility of cancellation and rebooking of forward contracts. Forward contracts can be cancelled at or before maturity depending on the view taken by the corporate on the future prevailing rates or due to some genuine reason, for example, delayed shipment of goods. For a forward sale by the customer to the bank, cancellation on due date is deemed as purchase by the bank at the contracted forward rate and a simultaneous sale at the then ruling spot rate. If the currency has appreciated beyond the forward rate, the difference is recovered from the customer; conversely, the gain, if any, is paid to the customer. The bank charges a flat fee every time the contract is cancelled.

Money Market Hedge

As opposed to the forward market, one may use the money market for the purpose of hedging transaction exposures. But for that, one has to have access to international money markets for short-term borrowings as well as investments. Essentially, money market hedge involves arbitrage between the Euro deposit market and the spot and forward foreign exchange market. An investor in choosing between assets denominated in different currencies looks for the highest possible return adjusted for exchange rate changes. And, since there is a great deal of uncertainty regarding exchange rates, arbitrageurs will arbitrage between various assets using forward contracts to take care of

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the exchange risk. This kind of arbitrage provides a link between foreign exchange markets and securities markets in different currencies and is called the covered interest arbitrage. Covered interest arbitrage links the forward premia and discounts directly with interest rate differentials between currencies. This will happen only in a free market where there is no exchange control or restrictions on the movement of funds. Let us assume, the following rates prevail in a free market:

US dollar interest rate : 5 % Rupee interest rate : 10 %

In this market condition, anybody would like to borrow US dollars, convert into rupees and avail of the higher interest rate on rupees. The clear profit-making opportunity will surely increase demand for US dollars as more players enter the market for making a profit. As a result, the dollar will begin to be quoted at a premium to the rupee while interest rate on dollars will move up and on rupees will fall. Ultimately, equilibrium will settle at a premium which will be exactly equal to the interest rate differential between the dollar and the rupee. What this means is that it should not matter to an investor in which currency he invests as higher interest rate yielding currencies are bound to be quoted at a discount in a free market. Thus, in efficient markets, covered investment in any currency would give the same returns. There are no riskless arbitrage profits to be had. This is the famous covered interest parity theorem. However, departures from this theorem exist because of transaction costs, political risks, withholding taxes on interest, government restrictions, etc. Because of such restrictions, significant difference may occur between the forward premia / discounts and Euro market interest differentials between two currencies. Such an imperfection will present opportunities for cost savings. A firm with planned receivables in a currency can hedge by borrowing in that currency so that the outflows on account of interest and repayments can be set off against the receivables. Conversely, the firm could obtain a forward cover and if the covered interest theorem prevailed, the forward discount/premium would be exactly equal to the interest differential between the two currencies. But, due to the departures from the covered interest theorem, there may be a cost saving using the money market hedge.