An Overview on the Impact of Hedging Techniques used in Foreign Exchange Market

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ABSTRACT *Today the aim of every business is to grow globally. The vision of every entrepreneur is to make his/her product manufactured be available throughout the world. In India globalisation started to spread rapidly in the late 1991 under the leadership of Narasimha Rao. He was then the Prime Minister of India who had initiated with various effective steps to encourage the Indian traders to engage in International trade. Major sectors were privatized and globalisation started spreading rapidly. The famous NCR which means Narasimha rao Committee Report,1991 introduced various trade measures which motivated the Indian traders to do business globally. The major challenges faced by traders in the international market were exchange rate fluctuations, lack of raw materials, price fluctuations etc., The authors here have discussed some major relief measures to overcome one among the above said problems which is the exchange rate fluctuations.*

Keywords: *International trade, forex market, exchange rate, risk, financial, exposure, price fluctuations, currencies*

1. Introduction

Forex reign currencies is termed as Forex market. It is wider than the stock market. Unlike Stock market the Forex market has no restriction on time as it functions 24/7. And therefore the international traders enjoy flexible financial transactions without any limitations. Exchange rate is a very important factor in international financial transactions. Risk in price fluctuations has always been a threat to the traders in engage in foreign trade. In order to protect the traders from this risk a term called 'Hedging' was started. Hedging is formally defined as a tool used to reduce the risk caused by price fluctuations in trade.

2.Forex Risk Management

Today every company is exposed to foreign exchange risk. It is because almost all companies engage in international trade. Trade engaged with different currencies is termed as international trade. Therefore the possibility of risk due to exchange rate fluctuations is higher in international trade. It is necessary for an organization to predict and find remedies and relief measures in times of extreme loss due to foreign exchange fluctuations. Hence the importance of Hedging techniques/methods are increasing at a higher rate. This tool helps the international traders to compensate the loss arising due to price fluctuations. The various methods used in Hedging are discussed below;

2.1 Methods of Forex Risk Management

Risk Management techniques are classified into internal and external techniques according to their basic origin. Internal techniques are mainly used as a part of company's regulatory financial management and aims at minimizing its exposure to exchange risk. These basically aim at reducing or preventing an exposed position from arising. The external techniques are used to provide protection against the possibility that exchange losses will result from the foreign exchange risk exposure which the internal measures have not been able to eliminate. These consist of basically the contractual measures to provide protection against an exchange loss which may arise from an existing translation or exposed position.

Some of the Internal Techniques are discussed below;

2.1.1 Internal Techniques

- **Netting**

Netting simply means offsetting the risk or exposure between currencies. It simply means, one currency risk is netted with the other same or another currency. The loss or gains in one currency is exposed to offset the loss or gains on the second currency. It is of two types bilateral netting and multilateral netting. In bilateral netting, each pair of subsidiaries nets out their own positions with each other. Flows are reduced by the lower of each company's purchases from or sales to its netting partner.

- **Leading and Lagging**

It refers to the adjustment of intercompany credit terms. Leading means making a prepayment or advancing payment in the trade obligations and lagging refers to making delayed in payment. Both methods are intercompany methods that are used as a risk-minimizing strategy or an aggressive strategy that maximizes the expected exchange gains.

- **Pricing Policy**

Pricing policy also helps the forex traders to offset the risk to some extent involved in trade. There are two types of pricing methods – price variation and invoicing policy. The companies in order to protect from exchange rate fluctuations they try to fix higher selling price so as to compensate the loss from price fluctuations. The other method is to make an internal agreement between the traders and prepare the invoice in the currency of the developed country among the two countries. This enables the small country to offset loss against exchange rate fluctuations.

- **Asset and Liability Management**

This technique can be used to manage balance sheet, income statement and cash flow exposures. It can also be used aggressively or defensively. The aggressive approach reflects to increase exposed assets, revenues, and cash inflows denominated in strong currencies and to increase exposed liabilities, expenses, and cash outflows in weak currencies. The defensive firm will seek to minimize foreign exchange gains and losses by matching the currency denomination of assets/liabilities, revenues/expenses and cash inflows/outflows, irrespective of the distinction between strong and weak currencies.

2.1.2 External Techniques

External techniques are used by both exporters and importers as well as by multinational companies. The costs of the external exposure management methods are fixed and predetermined. The main external exposure management techniques are forward exchange contracts, short term borrowing, discounting, forfeiting and government exchange risk guarantees.

- **Forward Exchange Contracts**

Forward exchange contracts refer to agreements in which two parties agree upon the exchange rate at which currencies will be exchanged on future date or within future specified duration. Forward contracts reduces exchange risk element in the foreign transactions. Price is paid for the protectionism and best-cost alternative should be chosen to reduce the cost of purchase. There is, however, some disagreement on how to calculate cost of forward cover mainly because there are two kinds of cost involved an ex-ante cost and an opportunity cost.

- **Short term Borrowing**

Another alternative to hedge risks in the forward market is the short-term borrowing technique. A company can borrow either dollar or some other foreign currency or the local currency. Through short term borrowing techniques, two major difficulties of the settlement dates and the continuing stream of foreign currency are easily solved. Short-term borrowing has some advantages over forward cover. The cost of short-term borrowing cover is the home currency amount which would have been received if the exposed receivable has been measurable. The foreign currency converted into home currency at the settlement dateless spot rate is the amount which the short-term borrowing technique yielded.

- **Discounting**

This technique is used to resolve the problems of continuing foreign currency exposures and uncertain settlement dates. The discounting technique for covering receivables exposures is very similar to short term borrowing. In discounting techniques, the effective discount rate less the home currency deposit rate rather that the foreign currency borrowing rate less the home currency rate as is short term borrowing techniques, is the cost. The basic aim in discounting is to convert the proceeds from the foreign currency receivable into the home currency as soon as possible.

In addition to the above techniques there are various other techniques adopted by the forex traders such as forfeiting, role of government agencies to help traders etc. Therefore in order to promote international trade and motivate the traders various methods are being used.

3.Conclusion

Hedging is a very important tool in international trade. This tool has reduced the traders to suffer from heavy loss and thus it has promoted traders to indulge in doing business globally. India being a developing country the exchange rate of rupee against any developed nation is high as compared to developed nation currencies. Therefore a small loss of Indian traders against developed countries currencies leads to a major loss. Hence hedging helps the small traders to safeguard against such destruction. And it has a great impact in forex market.

4. References

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