Chapter IV

HEDGING IN FORWARD AND MONEY MARKETS

Most corporates would like to avoid the risk associated with fluctuating foreign exchange rates. Consider an Indian exporter who is expecting a receivable of $ 1 million to mature three months from now. Being an Indian company, it would like to know with as much certainty as possible how many rupees it will obtain by selling the dollars. Unfortunately, since it does not know what the $ - Re rate would be three months from now, the company has an exposure. The company can hedge its risk in two ways. (In this chapter, we are not discussing the hedging mechanisms using futures and options. We shall discuss this in detail in subsequent chapters.) It could sell dollars forward at a rate which it can obtain from the bank today and thus know for certain the quantum of rupee inflows after three months. Alternatively, the company could borrow dollars such that the repayment of principal and interest after three months would exactly equal $ 1 million. The company can repay its loan with the receivables maturing after three months. Meanwhile, it does not really need the dollars it has borrowed today. So, it could convert into rupees and invest for three months at a rate of interest which is known today. In either case, the company knows with certainty what its rupee inflow would be after three months.

A similar approach can be used in the case of a $ 1 million payable. In this case, the company could buy $ 1 million forward at a rate which is known today. Alternatively, it could borrow rupees, convert into dollars and invest the foreign currency so obtained to ensure that the dollar investment maturing after three months will be just sufficient to settle the payable. Since it knows exactly how many rupees it will have to repay after three months, it has successfully locked in the cost of funds.

We can now summarise the rules for hedging receivables and payables using forward and money markets.

a) Receivables.

Using Forward market : Sell the receivable forward
Using Money market : Borrow the foreign currency today and repay with the receivable. Convert the foreign currency borrowed into home currency and invest.

b) Payables

Forward market : Buy the payable forward
Money market : Borrow the home currency, convert into foreign currency, invest the foreign currency so obtained to ensure that the investment can be used to settle the payable. Pay off the home currency loan.

In the case of multinational corporations which have dealings in several currencies simultaneously, the term home currency is misnomer. As far as an MNC is concerned, it should borrow in the currencies in which it has receivables and invest in the currencies where there are payables. In this way, it can ensure that at any given point of time, it has neither a long position nor a short position. Indeed, offsetting long and short positions is the essence of hedging.

A point which students should appreciate is that the main objective of hedging is minimisation of uncertainty. In the process of hedging, if exchange rates move against us, we are able to minimise losses. However, if the rates move in our favour, we also lose an opportunity to make windfall profits. The important point to note here is that as a hedger we feel more comfortable if we can avoid uncertainty even at the cost of forgoing a potential windfall profit. Thus, hedging does not attempt to increase profits or minimise losses. Rather, it removes uncertainty by telling us exactly at what cost we can lock in the exchange rate.

Another point which needs to be understood clearly is that in the long run, if we are dealing with a large number of foreign exchange transactions, by the law of probability, the rates would move in our favour sometimes and against us on other occasions. However, we can expect the two types of movements to cancel out. This means that in the long run, whether we cover foreign exchange exposure or not is immaterial. The question then arises why at all we need to take so much pains and incur heavy transaction costs associated with hedging. The answer to this question is fairly simple. If in the short run, we incur such huge losses, that we are wiped out, we would not get a chance to make up for our losses in the long run. Thus, it is important for a corporate to hedge its foreign exchange exposure. Of course, when the company’s treasure is confident about the direction of movement of a particular currency, he can take calculated gambles at times and leave the exposure uncovered. This indeed is a form of speculation.

Another useful principle to remember is that whenever we have the possibility of adjusting receivables and payables in the same currency, we must do so. This is because when we sell receivables, we get a lower price and when we buy payables, we have to pay a higher price. So, it makes sense to use receivables to settle payables in part or whole and vice versa. The adjustment of receivables and payables at a given point of time is called netting. In some cases, we may even be able to move cash flows over time by offering and accepting discounts so that receivables and payables in the same currency maturing at different points of time can be adjusted. If we are trying to move a receivable ahead in time, it is called leading. On the other hand, if we are trying to postponement the settlement of a payable, it is called lagging.