

Free global financing and exchange rate mechanisms report example

[Business](#), [Marketing](#)



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Currency Hedging

Introduction

Currency risk is an intrinsic aspect in the foreign market. The enterprises that operate in this environment have a variety of derivative instruments that can be used in connection with these risks. Managing these risks requires enterprise wide coordination otherwise; these international exposures will affect the value of the currency. Therefore, global equity portfolio managers have resulted in a variety of methods to currency hedging to manage the uncertainties in the foreign market. This is so because currency hedging reduces the financial risk, which occurs in the foreign market. Therefore, the paper will evaluate the currency hedging and how it is used in global financing operations as well as its importance in managing risks

Currency Hedging

Currency hedging involves eliminating financial risk by passing that risk on to someone else. It can offer certainty of cash flows, which assist with

budgeting, encouraging management to undertake investment, in addition, it helps to reduce the chance of financial collapse and protect attractive companies from any exposures. For instance, foreign hedging currency tries to decrease the uncertainties that arise due to movements in an exchange rate. This is a two-way risk because the exchange rate can move adversely or favorably. However, management tends to hedges for adverse movements only especially on higher costs and reduced income. Therefore, money market hedge can be used to reduce foreign currency risk by trading the currency today on the spot market. In order to achieve this, the interest, which might be stable, is used where the interest rate parity theory links the interest and exchange rate. This ensures that when exchange rates vary then the interest rate is expected also to vary.

Currency hedging in global financing

Every transaction that takes place between economic agents of different countries is always accompanied by currency exchange. However, exchange rates are often fluctuating and result in severe volatile in the floats, which brings the currency risk to agents. There are different agents involved in the hedging currency in the domestic or foreign market. The agents who are risk averse seek to hedge whenever erratic currency risks are exposed. In contrast, agents who are not necessarily risk-averse may hedge currency or fail to hedge. Therefore, two types of hedgers, which include constant and speculative hedgers, demonstrate hedging performance. The constant hedger always hedges currency while speculative hedgers can hedge or fail to hedge based on his or her expected returns stances (DeRosa, 2009).

Therefore, the higher the volatility of agent's net cash flow due to accumulated currency risks, the higher their financial challenges. In this circumstance, locking in the domestic money value of the foreign currency becomes a big issue, especially on minor and major currencies. This is so because challenges are encountered when hedging for these currencies. Major currencies refer to currencies traded in liquid markets while minor currencies are traded in much less liquid markets.

The hedging instruments for major currencies are widely traded, but minor currencies are thinly traded. The agents who have some minor currencies issued by developing countries cannot help taking a currency risk. This explains why developing countries find it challenging to perform currency hedging. This is so because there is little correlation of common information between developing countries and other developed countries because the fundamental association between hedged and hedging currency are thinly stable (Henderson, 2006). Meanwhile, in the case of minor currency, none of a single hedge instrument passes the threshold of hedging effectiveness. Similarly, extra challenges are experienced in the developing countries when hedging the risks for currencies whose hedging instruments are little traded. For instance, when foreign hedger rather than a hedger living in a developing country finds himself or herself holding a minor currency in a cash position, a possible option for hedging will be to use a single proxy major currency or multiple proxy major currencies.

Importance of Currency hedging in managing risks

Research indicates that hedging risk was not beneficial for global portfolio managers with exposures to equity markets in developed and emerging market countries in the recent years. Hence, many international investors not only think about the foreign currency positions they would like to hold but also about the currency hedging strategy they should employ. For instance, an unhedged position in the international equity tends to correspond to a net zero position in foreign currency (Coyle, 2000). This is so because when currencies and equities are not correlated, risk management demands for foreign currencies are zero due to the absence of speculative demands. For instance, the United States investors can reduce volatility by completely hedging the currency exposure in international diversified equity and bond portfolios. Thus, the optimal currency hedging mainly reduces risk for equity investors in the foreign market.

Speculative currency demands emphasize that investors should receive a positive expected excess return on foreign currencies. An exceptional feature of currencies is that investors in the different global markets can simultaneously recognize positive expected excess returns on foreign currencies over their own currencies. For instance, this means that investor in America can preserve a positive expected excess return on Euros over dollars while a European investor can also perceive a positive expected excess return on dollars over Euros (Coyle, 2000). This possibility is known as the Siegel paradox, which explains symmetric speculative demand for foreign currency, by investors based in all countries.

Research indicates that high-rate currencies are exposed to the risk of rare

economic disasters and emerging market currencies have higher sensitivity to the united state consumption growth. When using sensitivity to international stock returns as a measure of risk, market currencies with higher unconditional average interest rate tend to have higher betas with the international market stock. However, there is no guarantee that the currency whose interest rate is temporarily high will have a temporary higher risk. This is so because currency beta has a weak tendency to decline when interest rates increases (Clark and Ghosh, 2004). Risk considerations might discourage equity investors from implementing an unconditional form of the international trade. However, an investment in the international market that invests in currencies with temporarily high returns are attractive to risk-averse equity investors.

Conclusion

In a recap, whether international portfolio should be hedged against currency risks has initiated a great debate. This is so because of the issue of international asset pricing model and optimal hedging in the futures markets. In the international asset-pricing model, optimal portfolios contain positions in forward contracts. These positions, which can differ from the positions, have been referred to as hedges. Hence, hedge ratio should be identical for all investors despite their nationality and that investors should never completely hedge their foreign currency exposures. Similarly, the futures market produces demands for hedging instruments that contain both hedging and speculative components. Thus, adding forward contracts to

international portfolio improves the risk-return profile of global investments significantly.

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