Currency hedging

Economics, Financial Markets

‘ Hedging’ is a very commonly used term in the field offinanceand investment. Hedging practices are common to businessmen and other investors all over the world. It is an activity that involves a certain amount of risk but then, every financial activity is a risk. Relatively, hedging is a less speculative and safer option if a person wishes to see hismoneygrow while on investment. Technically speaking, hedging is a policy wherein the major objective of the investor is to get insurance against the risk he has incurred by investing in another investment.

It can be said that hedging is an activity by which a person can minimize exposure to an unwanted or unexpected or unnatural risk while still allowing certain profits from an investment. Market ups and downs as a whole do not actually affect a hedger’s investment as long as the under priced entity that he has invested in increases in its value. It is for this reason that hedgers usually indulge in investments in entities that are under priced compared to its actual value.

This difference between an entity’s theoretical value and its actual value is termed as basis and hedging activities are generally termed as speculation in basis since it is the basis that determines the profit, market ups and downs notwithstanding. Hedging practices are of many kinds. However, in this paper we are concerned with currency hedging. This practice is becoming very common with increasingglobalizationand people investing in foreign currencies and foreign markets.

This not only controls the natural risks of investing in a foreign currency but also appreciates the investment over time. CURRENCY HEDGING There are some financial investors for whom dealing in foreign currencies and

operating in foreign markets is a must. The nature of their business activity is such they cannot avoid the dealings in foreign currencies. For such people, currency hedging becomes a valuable practice as it provides them insurance against the natural risks of operating in such conditions and in currencies that may be volatile or liable to speculation.

Same is applicable to investors who invest their money in foreign markets and wish to have an insurance against the aforementioned troubles. It has become a common practice in the present times to outsource the manufacturing work to countries in Asia such as China, Taiwan, India, Indonesia etc as the labor cost is much lower in these economies. However, this outsourcing also involves a number of unforeseen risks, the major ones being the risk of operating in an unknown country, unknown economy and an unknown currency.

The volatility of a currency in which a businessman is producing as well as the currency in which he is selling may sometimes cut into his profits, make his profits disappear or in extreme cases, take him into loss. Even with a lot of careful planning and budgeting, such situations may arise and nothing can be done to reverse them. Such problems arise only when the cost currency is different from the sales currency. If both cost and selling operations are in the same currency, no currency risks are present. Currency risks are of two main types.

They may be transaction risks which determine how much the volatility in exchange rates will affect the actual cash flow of the company. The other kind of risk is the translation risk which determines the effect of changes in exchange rates on balance sheet items and earnings. It is more of an

accounting risk. For businessmen, the transaction risk is obviously more relevant and more problematic. It is not only businessmen who face the currency risks. Financial institutions that are engaged in the business of lending and borrowing of money in various currencies may also face such problems with the varying currency conversion rates.

For an insurance against such circumstances, currency hedging is used. OPTIONS IN CURRENCY HEDGING Currency hedging is usually done through the creation of future contracts or forward contracts. Both are similar in some respects but have certain varying features discussed later in the paper. However, it needs to be underlined that while hedging will minimize the risk or the loss from an unfavorable change in the currency conversion rate, it will not provide any benefits from a favorable conversion rate.

The profitability of a hedging contract is also not a relevant issue because the main objective of such a contract is to minimize risk and not earn money. A hedging contract principle is easy to understand. The main activity is to create a portfolio which consists of two commodities. One of them is a long term standing and the other is a short term standing (both in the foreign currency) and they are such that when there are losses in any one commodity due to an unfavorable change in the conversion rate, the other appreciates and offsets the losses.

Generally, the commodities used for this purpose are those whose price movements can be seen similar to the changes in the cash markets. A future contract draws up all the issues and features of the transaction describes above. It lists the quality, quantity and the price of the commodity being purchased. It also notes the date of transaction and the way the commodity

is going to be delivered to the investor. The prices of the commodities fluctuate in the markets. The difference between the actual price and the future price is termed as the basis.

Both forward and future contracts provide the same type of benefits but they have some basic difference. One of them is that while future contracts necessitate daily marketing, forward contracts require marketing only after the expiration of their contract period. Also, the prices in future and forward contracts are usually similar, differing only when future prices tend to be affected by the interest rates. There are however many disadvantages with the future and forward contracts.

The most obvious disadvantage is that while they minimize risk from and unfavorable shift in exchange rates, they do not provide any benefit if the exchange rate becomes favorable. Thus they have to be operated on an almost no profit- no loss basis. Also, they provide no cushion against the problems that may arise in future transactions that are currency dependent. To counter these problems, the investors can make use of options. The options are basically rights that are given out to the investors to buy or sell a certain pre-fixed amount of foreign currency at a specific price.

The options thus are of two types. Call options are for buying foreign currency and they are profitable when exchange rate increases as they allow the buyer to buy at a lower rate. The other type of options is the put options which are used for selling foreign currency and make money when the exchange rate falls below the specified level. Both kinds of options may follow the American pattern wherein they can be exercised at any time even

before the date of expiry or they may follow the European pattern which allows the user to exercise them only after the date of expiry has passed.

Currency hedging can also be done through ‘ hedge funds’. These funds basically transfer the risks of a volatile currency to those who are actually interested in investing in that particular currency. This benefits both the sides. The investor is, in effect, making an investment in his home currency but in a foreign economy. To hedge the risk of currency, the investor finds a company or person who wishes to invest in that particular currency. The investment of the hedger thus, becomes the capital for the other person who takes the risk upon him willingly.

Thus, this system is beneficial for both the parties. The hedge funds provide this service to the investors. They find the parties who are willing to make such investments in the foreign companies at a certain extra payment. This is obviously similar to the insurance services provided by insurance companies which guard against risks. This is however a comparatively crude method of currency hedging as compared to the ones discussed above. CONCLUSION It is obvious that in the global market of the modern era, dealing in foreign currency and in foreign markets is becoming an absolute necessity.

However, in addition to the benefits of global markets such as the low labor costs and vast untapped markets, the global business brings the risks involved in dealing with an alien currency and in an alien market. Currency hedging thus becomes a necessity if people wish to expand their business globally. The main objective of a hedging activity is the minimization of risks involved. The most commonly used hedging techniques i. e. the future or

forward contracts provide this security but do not add to the profits if the speculation is favorable to the investor.

Options do provide this opportunity to expand profits from favorable changes in currency conversion rates. Hedge funds may also be used for the purpose of currency hedging. However, the ultimate choice lies in the hands of the investor and must be made only after assessing the merits of all types and also with the consideration of the type of business activity one is engaged in.

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