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CORPORATE HEDGING AND FOREIGN EXCHANGE RISK IN INDIA

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Abstract

With the globalisation of Indian economy and simultaneously dismantling the trade barriers facilitated the domestic economy to integrate with international economy. This made Indian business to expand globally and more prominently. The foreign capital flooded into India. This eventually increased the revenues and expenses, and in turn inviting greater exchange rate exposures by adversely impacting the company financials. In the light of the above, Indian firms are resorting to use financial risk management tools and techniques to mitigate the Foreign Exchange Exposure. This study aims to provide a perspective on managing the risk that firms face due to fluctuating exchange rates.

Keywords: *Globalisation, Indian Economy, Foreign Capital, Financial Risk, Foreign Exchange Exposure.*

Introduction

In 1971, the Bretton Woods system of administering fixed foreign exchange rates was abolished in favor of market-determination of foreign exchange rates; a regime of fluctuating exchange rates was introduced. Besides market-determined fluctuations, there was a lot of volatility in other markets around the world owing to increased inflation and the oil shock. Corporate struggled to cope with the uncertainty in profits, cash flows and future costs. It was then that financial derivatives – foreign currency, interest rate, and commodity derivatives emerged as means of managing risks facing corporations. In India, exchange rates were deregulated and were allowed to be determined by markets in 1993. The economic liberalization of the early nineties facilitated the introduction of derivatives based on interest rates and foreign exchange. However derivative use is still a highly regulated area due to the partial convertibility of the rupee. Currently forwards, swaps and options are available in India and the use of foreign currency derivatives is permitted for hedging purposes only. This study aims to provide a perspective on managing the risk that firms face due to fluctuating exchange rates. It investigates the prudence in investing resources towards the purpose of hedging and then introduces the tools for risk management. These are then applied in the Indian context. The motivation of this study came from the recent rise in volatility in the money markets of the world and particularly in the US Dollar, due to which Indian exports are fast gaining a cost disadvantage. Hedging with derivative instruments is a feasible solution to this situation. With the globalisation of Indian economy and simultaneously dismantling the trade barriers facilitated the domestic economy to integrate with international economy. This made Indian business to expand globally and more prominently. The foreign capital flooded into India. This eventually increased the revenues and expenses, and in turn inviting greater exchange rate exposures by adversely impacting the company financials. In the light of the above, Indian firms are resorting to use financial risk management tools and techniques to mitigate the Foreign Exchange Exposure.

Foreign Exchange Risk Management: Process and Necessity

Firms dealing in multiple currencies face a risk (an unanticipated gain/loss) on account of sudden/unanticipated changes in exchange rates, quantified in terms of exposures. Exposure is defined as a contracted, projected or contingent cash flow whose magnitude is not certain at the

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