

Hedging for Export Business

International Legal Framework for Foreign Trade

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Introduction

- ▶ Exporting goods or commodities abroad involves various types of **risks**.

- ▶ Typical export risks are:
 - Credit risks
 - Poor quality risk
 - Transportation and logistic risks
 - Legal risks
 - Political risks
 - Unforeseen risks
 - Exchange rate risks
 - Cultural and language risks

Foreign Exchange Risk

- ▶ Fluctuations in the foreign exchange rate can have significant impact on business decisions and outcomes.
- ▶ Many international trade and business dealings are become unworthy due to significant **exchange rate risk**.

Definition

*Exchange rate risk is occurs due to the uncertainty in the future value of a currency. Exchange risk can be avoided by adopting **Hedging**.*

Hedging

Definition

Risk management strategy used in limiting or offsetting probability of loss from fluctuations in the prices of commodities, currencies, or securities.

Instruments

▶ **Forwards/Futures**

- *Forward contracts* are customized agreements between two parties to fix the exchange rate for a future transaction.
- *Futures contract* is similar to the forward contract, but they are standardized and much more liquid.

Hedging (Cont'd)

- ▶ **Options**

Currency options are financial instruments that give the owner the right but not the obligation to buy or sell a specific foreign currency at a predetermined exchange rate.

- ▶ **Swaps**

A swap is a foreign currency contract whereby the buyer and seller exchange equal initial principal amounts of two different currencies at the spot rate.

Forward Contracts

- ▶ The idea behind **forward contracts** is that as the **exchange rate** is **locked** on both sides, both parties do not have to worry about **fluctuations** in the income and expenditure respectively.
- ▶ In the short term, firms using forward contracts can make **gains** or **losses** from hedging.



Forward Contracts (example)

- ▶ Firm receives an export order with the delivery date being in 3 months time.
- ▶ The contract is worth - **\$US 100,000**
- ▶ At the time the contract is placed, the New Zealand dollar is worth **\$US 0.65**
- ▶ Therefore, the value of order is $\$100,000/0.65 = \text{\$NZ } 153,850$
- ▶ Value of \$NZ changes on payment date to **\$US 0.68**
- ▶ Consequently, the firm will get only **\$NZ 147,058** ($100,000/0.68$) rather than **\$NZ 153,850**

Forward Contracts locks payment at a particular exchange rate for a pre-specified rate in the future, irrespective of what the actual market exchange rate at that time is.

Conclusion

- ▶ Hedging refers to managing **risk** to an extent that makes it **bearable**. Hedging is a **transfer of risk** without buying insurance policies.
- ▶ A **forward exchange rate contract** involves contracting to buy or sell a foreign currency at a future date at an agreed exchange rate. This completely **eliminates currency risk**.

Conceptually, hedging brings two sources of welfare gains:

1. Stabilizing export income leads to a steadier level of consumption.
2. Hedging allows the exporting country to save on its stock of international reserves.

Thank You for Your Attention

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