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FOREIGN EXCHANGE EXPOSURE MANAGEMENT: A SYSTEMATIC APPROACH

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ABSTRACT

With the wide spread of globalization and liberalization, no business unit is being spared of dangerous effects of internationalization. As a result of it, every company whether or not engaged in any international business activity is exposed to some or the other foreign exchange risk. The foreign exchange risk may be transaction exposure, translation exposure or economic exposure. The high volatility of exchange rates imposes a big challenge for management of foreign exchange exposure. Success of a business firm largely depends on how effectively it manages foreign exchange risk. Foreign exchange risk management must be conducted in the context of a comprehensive business plan. This article sets out step by step procedure that an MNC should follow in order to manage its foreign exchange exposure. The article lays emphasis on regular review of hedging strategies for the purpose of efficient exposure management.

KEYWORDS: *Exchange Rate Fluctuations, Foreign Exchange Exposure, Economic Exposure, Exposure Management, Financial Derivatives, Hedging Strategies, Transaction Exposure, Translation Exposure.*

1. INTRODUCTION

The foreign exchange exposures emanating from unexpected corner have a definite impact on the company. When there is a condition prevalent where the exchange rates become extremely volatile the exchange rate movements destabilize the cash flows of a business significantly. Such destabilization of cash flows affects the profitability of the business. This is known as foreign exchange exposure. The magnitude of foreign exchange exposure has increased at a mind boggling rate in the recent times. Tackling these exposures is the biggest challenge that companies face today. It requires a broad based proactive risk management approach at the strategic level. If a firm uses more diversified portfolio it can set off its losses by gains in other transactions.

2. LITERATURE REVIEW

Bradford Cornell and Alan C. Shapiro, in their article, “Managing Foreign Exchange Risks”, provide step by step guidance for the formulation of an effective strategy for managing currency risk. First step is to determine the extent of its exposure to currency risk. Second step is to identify the objectives of its exchange risk management program. Third step is to design a set of companywide policies to achieve its objectives. It is observed that the changes in security prices generally reflect changes in cash flows rather than reported earnings. Currency risk affects all the facets of a company’ operations and therefore, should not be the concern of financial managers alone. Operating managers should develop marketing and production initiatives that help to ensure profitability over the long run. Most companies earn their keep because of their superior marketing, production, organization and technological skills. This article also pointed out the alarming need for the creation of a committee including senior officers and top functional executives in order to adopt an integrated approach for managing foreign currency exposure.

Ian H. Giddy and Gunter Dufey, in their article “The Management of Foreign Exchange risk”, explore the impact of currency fluctuations on cash flows, on assets and liabilities and on the real business of the firm. The article portrays a thumbnail sketch of foreign exchange exposure management. It is demonstrated that there are numerous realistic situations where the economic effects of exchange rate changes differ from those predicted by the various measures of translation exposure. It emphasizes the distinctions between the currency of location, the currency of denomination and the currency of determination of a business. It also deals with the thorny question of how to approach currency forecasting. It suggests some basic principles which may guide companies in managing their foreign exchange risk.

Jeffrey B. Wallace, in his report on “The Group of 31 Report: Core Principles for Managing Multinational FX Risk”, presents an authoritative list of foreign exchange risk principles appropriate for multinationals for which foreign exchange risk management is neither a core activity nor a profit-making one. With GM, he formed a group of 31 (“G31”) world-class multinationals: 16 American, 13 European and two Japanese companies with average sales of $50 billion. He proposed twelve basic principles which can be used for the purpose of managing foreign exchange exposure. He concludes that all corporate policies, especially good ones that have been developed with much thought and effort, run the risk of being applied mechanically despite changing circumstances. External changes such as new international economic conditions, currencies, derivatives, accounting standards and tax regulations as well as internal changes due to increased operating growth, industry competition, major acquisitions and divestitures, etc. are all reasons which can force companies to establish a formal review process to assess every two or three years whether current foreign exchange policies and procedures are still adequate and appropriate. The study proposed for the establishment of Risk Committee which will act as an ideal vehicle for the review of hedging.

Sriprasanna Ramesh, in his report, “A project on Trade Finance, Foreign exchange and Exposure management”, has discussed the various sources of trade finance, foreign exchange market, foreign exchange exposures and techniques to manage them. Transaction exposure is the risk that exchange rate can move in adverse direction from the time transaction is entered till the time transaction is settled. Translation exposure arises from the need to translate foreign currency financial statements into the home currency. Economic exposure is the risk that a change in exchange rate affects a company’s competitive position in the market and thus affecting overall profitability in long term. A good foreign exchange policy is critical to the sound risk management of any company. The most desirable method of risk management is the pre-planning of responses to exchange rate movements. This approach helps eliminate the panic factor as all outcomes have been considered including worse case scenarios. Derivatives have come into existence because of the prevalence of risk in every business. Derivatives provide a means of managing such risks. The common derivative products are forwards, future, options and swap. Forward contracts are suitable to hedge transaction exposure. Currency options are useful tools to limit losses and for unlimited access to unlimited profit potential in volatile market.

3. TYPES OF FOREIGN EXCHANGE EXPOSURE

Foreign exchange risk means chances of variations in the value of one currency in terms of another currency. Fluctuations in exchange rates are inevitable. It may result in foreign exchange gain or loss. Anticipated exchange rate changes do not impose any risk. More critical are unanticipated exchange rate changes which may entangle firm in danger. Foreign exchange exposure is what is at risk of exchange rate variations. It is a measure of sensitivity of firm’s cash flows of changes in exchange rate. It can be measured by examining how the market value of the firm and present value of its expected cash flows respond to changes in exchange rates. A company that conducts even some of its business activities in another currency is exposed to such risks. Indeed exposures can arise even for companies with no income, expenditure, asset or liability in a currency different from the balance-sheet currency. The impact of exchange rate fluctuations can be described in form of three types of currency exposures - transaction exposure, translation exposure and economic exposure which are explained as below:

3.1 TRANSACTION EXPOSURE

While buying or selling products in any foreign currency, there is always a time gap between the dates of entering into a contract and its final settlement. During this time gap, the business firm is exposed to exchange rate fluctuations. These fluctuations may be favorable as well as unfavorable. The unfavorable fluctuations may turn a profitable deal unprofitable by the time of actual settlement of contracts. The longer the gap between the signing and completion of a contract, the higher will be the level of exchange rate risks. For all their international dealings such as export/import or borrowing/lending, MNCs need to convert domestic currency into foreign currency and reconvert it into domestic currency. Transaction exposure involves known and certain cash flows so the exposure is easily identifiable and quantifiable. The multinational companies which have their subsidiaries located in different countries enjoy the benefit of netting and cross currency relations. Changes in the value of different currencies may push its overall transaction exposure in different directions. There is consolidated net transaction exposure which depends not only on inflows and outflows but also upon the correlation between the changes in the value of different currencies. In case of positive correlation, the magnitude of transaction exposure will be large but in case of negative correlation, net transaction exposure will be comparatively less.

3.2 TRANSLATION EXPOSURE

Translation risk refers primarily to the impact of exchange rates on earnings and balance sheet items when consolidating financial statements from foreign subsidiaries. It arises from the need to "translate" foreign currency assets or liabilities into the home currency for the purpose of finalizing the accounts for any given period. Multinational corporations having operations in many countries have to prepare their consolidated financial statements to have a complete knowledge of result of all of their business operations. Usually, foreign subsidiaries prepare their accounting records and financial statements in the currency of the country where they operate. For this, it is necessary to translate foreign currency denominated accounts of subsidiary companies into the currency of parent company. But the currency fluctuations can create currency gains or losses from such translations. Translation exposure does not represent real movements of cash between different currency systems, but can clearly impact both the consolidated profit and loss account and the consolidated balance sheet. The balance sheet effects are often dismissed as illusory since they have no impact on cash. However the level of assets and liabilities can affect financial ratios which are calculated using the balance sheet figures.

3.2.1 METHODS OF TRANSLATION

A) TEMPORAL METHOD

This method considers the method of evaluation to decide the exchange rate to be used for translation. Since the current assets are to be evaluated at market values, these are translated at current rate. Current rate is the rate of foreign exchange as on balance sheet date. The fixed assets are evaluated on historical cost basis that’s why these are translated at historical rates. The items, which are carried at historical cost, like cost of goods sold, depreciation, amortization expenses etc. are to be translated at historical cost. Likewise all the receivables, payables and cash etc. are to be translated at the current rate. In case of components of income statements when revenue and expense items are numerous, the company can use an average rate during that accounting period. Otherwise these items are to be translated at the exchange rate prevailing at the time when these transactions actually took place.

B) CURRENT RATE METHOD

Under this method all the components of balance sheet and income statements are translated at current exchange rate. When foreign currency denominated assets are greater than foreign currency denominated liabilities, then company will enjoy gains as a result of revaluation and it will suffer losses as a result of devaluation.

C) CURRENT/ NON CURRENT METHOD

Under this method, it is presumed that the effect of exchange rate fluctuations depends on the maturity of the assets and liabilities. That’s why current liabilities and current assets are to be translated at the exchange rate prevailing on balance sheet date whereas non-current liabilities and fixed assets are to be carried at historical exchange rates. The expenses which are related to these assets like depreciation etc. are to be translated at a rate used for translation of related assets. The components of income statement are to be translated at the average rates.

D) MONETARY/ NON MONETARY METHOD

This method presumes that monetary and non monetary items respond to exchange rate fluctuations. The monetary items of balance sheet i.e. monetary assets and monetary liabilities are to be translated at current rates. The historical rate is used to translate non-monetary assets, non monetary liabilities and share capital. The components of income statement are to be carried at the average rate.

3.3 ECONOMIC EXPOSURE

Economic exposure reflects the extent to which the present value of future cash flows is affected by exchange rate movements. It is the most pernicious and harmful exposure confronting business in a world of volatile exchange rates. A change in exchange rate affects the company's competitive position in the market and hence indirectly it affects the profitability of business over a longer time span than transaction and even translation exposure. Shifts in real exchange rates pose more threat than that of nominal exchange rates. As Indian Rupee floats freely on the trade account, currency risk is likely to become a serious problem with the Indian companies attempting to internationalize their business. Real exchange rate is adjusted for the inflation. It affects a number of aspects of the firm's operations. It affects the change in the value of the firm. The significance of changes in the value of competitors' currencies, which appear unrelated to firm's operations, cannot be underestimated. It is important to appreciate a competitor's ability to take a greater market share or larger profit because changing exchange rates have moved in his favor.

3.4 FOREIGN EXCHANGE EXPOSURE MANAGEMENT

Foreign exchange exposure management is a multi-staged process which involves strategies, techniques and an approach for recognizing and confronting any threat faced by the firm due to exchange rate fluctuations. The degree of efforts essential for foreign exchange exposure management depends on the fact that how sensitive is an enterprise to exchange rate fluctuations. Foreign exchange exposure management aims to forecast and turn the spotlight on the likely trouble spots, long before they become major issues. Foreign exchange exposure management should be integrated with the operating side of the business. Therefore the treasurer should liaise with other departments on decisions on production, purchasing and management as these can all have currency implications. They have to take lively interest to take appropriate and timely action in terms of restructuring their operations to respond to changes in exchange rates so that they are able to maintain their competitive advantage despite the dark clouds. Foreign exchange exposure management can not eliminate foreign exchange exposure completely. But the planned course of action brings risk to manageable level. Losses can be minimized only if accurate and comparable quantitative foreign exchange exposure related information is communicated timely to senior management. As the situation is dynamic and ever changing, the activities related to the foreign exchange exposure management should be evaluated periodically and updated from time to time to ensure minimization of targeted risk.

3.5 SIGNIFICANCE OF FOREIGN EXCHANGE EXPOSURE MANAGEMENT

Volatility of exchange rates has increased the complexity of cross border financing activities. Though the relationship between exchange rates, interest rates and inflation rates shows that in long run a firm will not experience any exchange losses or gains. But in reality these equilibrium conditions rarely hold in the short & medium term. The temporary deviations can even create disasters. As a result of change in exchange rate, importers may require to pay extra for their imports, exporters may get lesser value for their exports, borrowers may required to pay extra and lenders may recover less. It is also possible that a viable foreign investment project may twin into a exchange rate fluctuations. With regard to non-financial business firms the problem is much more complex, as the core assets of such firms, such as inventories, plant and equipment do not have contractually fixed returns. The expected returns may well be significantly affected by exchange rate changes and therefore affect the value of the enterprise. This issue is clouded further by the fact that financial results for an enterprise tend to be compiled by methods based on the principles of accrual accounting. This means that the data provided are not those that are really relevant for business decision making, namely future cash flows and their associated risk profiles. A firm with high foreign exchange exposure cannot borrow much in international market and thus fails to avail advantage of leverage shield. Unmanaged foreign exchange exposure can cause significant fluctuations in the earnings and the market value of the firm. Any decline in the value of firm will have ultimate impact on shareholders. The resulting variability of net cash flow is of significance as it can subject the firm to the cost of financial distress or even default. It is usually supported that earnings fluctuations that threaten the firms continued viability absorb management and creditors time, entail out of pocket costs and also create a variety of operating and investment problems. Thus, foreign exchange exposure management has become alarming need of all business enterprises.

4 PROCESS OF FOREIGN EXCHANGE EXPOSURE MANAGEMENT

Volatility of exchange rate has a very crucial effect not only on measurement of foreign exchange exposure but it also affects management of foreign exchange exposure. Virtually all aspects of a corporate may be influenced by changes in exchange rates. Foreign exchange exposure management is a systematic process in order to minimize the uncertainty of future transactions denominated in a foreign currency and providing some stability to earnings and cash flows. Almost all corporate treasurers have found the foreign currency exposure management to be the most difficult and onerous, indeed a terrifying challenge, but perhaps also the most exciting, and occasionally as a rewarding activity. The process of foreign exchange exposure management can be explained as below;

4.1 IDENTIFYING NATURE OF FOREIGN EXCHANGE EXPOSURE PROCESS

The process of foreign exchange exposure management starts with identification and analysis of foreign exchange exposure. With the help of past year experiences, company should try to identify the nature of exposure; transaction exposure, economic exposure and translation exposure. In fact, exchange rate exposure varies widely depending on the nature of their foreign activities. Exposure varies from the large positive net exposure to the large negative net exposure. Company should make efforts to identify the areas of effect of exchange rate fluctuations. Imports and exports are the primary source of foreign exchange risk among Indian businesses. It arises at the time of actual conversions of cash flows from one currency to another. Export oriental firms have very large positive exposure as their foreign currency revenue exceed their foreign currency costs. They experience a large increase in their profits when home currency depreciates. Net importers have very large negative exposure. Foreign exchange exposure is quite low for those firms who have been able to match their foreign currency revenues and costs quite effectively. Multinational firms can shield themselves from most of the exchange rate exposure due to their foreign sales be creating offsetting foreign currency costs through locating plants abroad. Firm should keep an owl eye on impact of foreign exchange fluctuations or revenues and cash flows. It should identify its contractual and expected foreign currency cash inflows and outflows. All those transactions must be further analyzed for their timings and variability. In order to make a fair analysis company should also consider cash inflow – outflow mismatches, timing mismatches and currency portfolio mix.

4.2 ANALYZING DETERMINANTS OF EXCHANGE RATE

The next step is to analyze the determinants of exchange rate. Some of the determinants are explained as below;

A) FORCES OF DEMAND AND SUPPLY

Exchange rate is established as a result of equilibrium between the forces of demand and supply of any currency. There can be no fixed exchange rate. It keeps on fluctuating every moment as both demand and supply of currency in foreign exchange market change continuously. Whenever there is any rise in domestic price, there will be decline in export earnings and increase in imports. The demand for foreign exchange will increase which leads to depreciation of domestic currency. When there is rise in domestic interest rate, the capital inflow will increase. Increased supply of foreign exchange will result in appreciation of domestic currency. The changes in capital and current account of balance of payment also affect exchange rates. Increased exports result in an increased supply of foreign exchange relative to the supply of domestic currency. It will result in the domestic currency’s appreciation. Increased imports will result in increased demand for foreign exchange relative to the demand for the domestic currency. It will result in the domestic currency's depreciation. More over holding of financial assets domestic and foreign bonds also affect exchange rate. Whenever there is any change in interest rate, real income, price level, wealth and risk, investors make adjustments in their portfolio which will affect demand and supply of these financial assets. It will bring changes in exchange rate.

B) POLITICAL FACTORS

The exchange rate is effected by many of the political factors such the monetary policy of government, government plans on the various items like money supply, inflation, taxes, and deficit financing. When any government actively intervenes in the foreign currency markets with the help of central bank, the exchange rate is affected up to a great extent. Political stability also affects exchange rate.

C) PSYCHOLOGICAL FACTORS

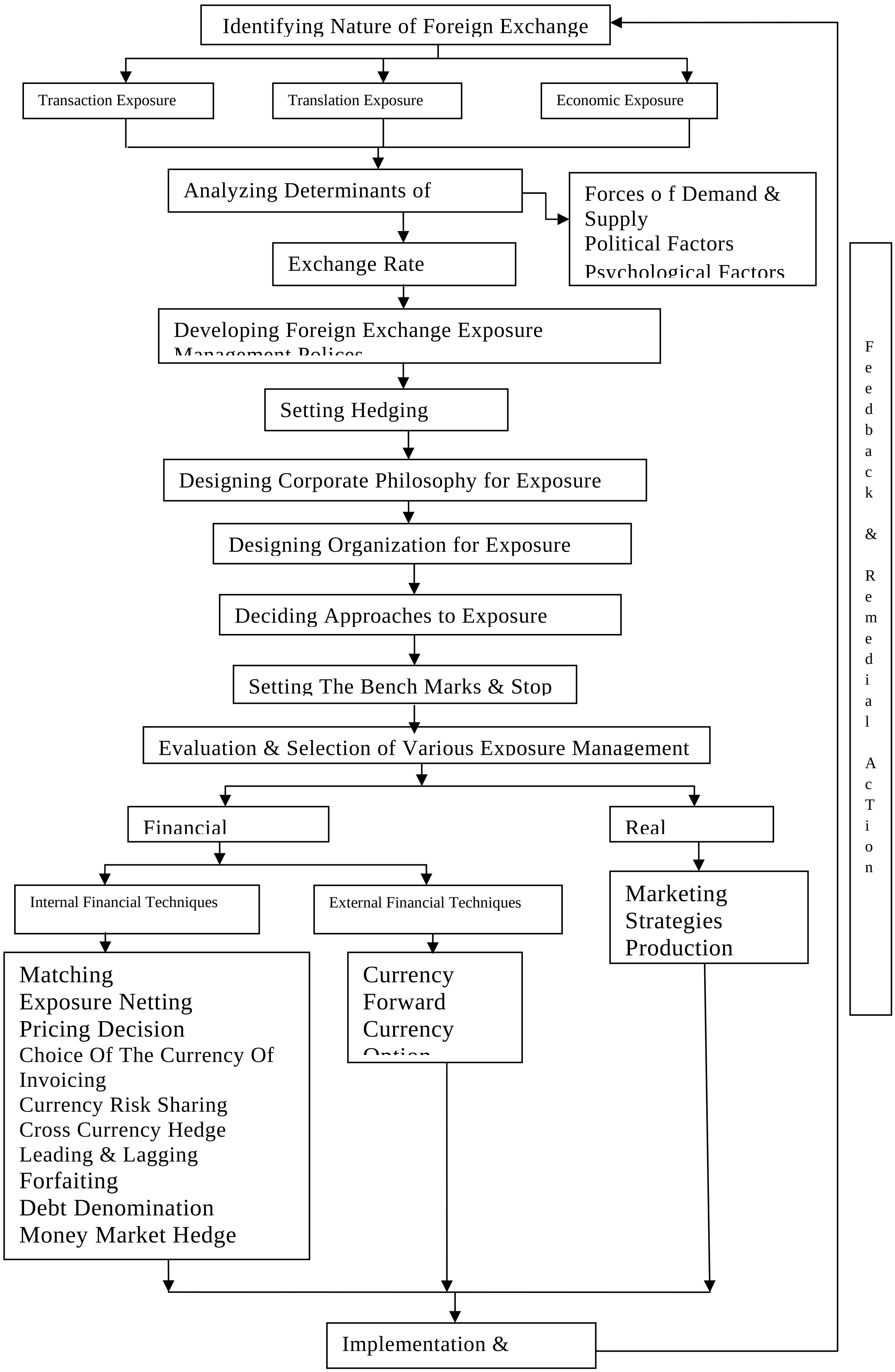
Psychological factors like; market anticipation, speculative pressures, and future expectations also influence exchange rates. Any event, from a declaration of war to a fainting political leader, can take its toll on a currency's value.

D) ECONOMIC FACTORS

Economic factors such as hedging activities, interest rates, inflationary pressures, trade imbalances, and euro market activities have a great impact on exchange rate. Four ways equivalence model explains the relationship of exchange rate with different economic variables such as interest rate and inflation rate.

4.3 EXCHANGE RATE FORECASTING

Forecasted exchange rate acts as an important input for planning purposes. It helps in making the decisions like; hedging decision, working capital management, long-term investment analysis, long-term financing decision, and other decisions. Forecasting is required in order to decide whether to go in for hedging or not. The task of forecasting foreign exchange rates for planning and decision-making purposes is quite difficult process which requires special expertise in forecasting. A technician believes that clues in the past movements lead them to the future. If foreign exchange markets are perfectly efficient, exchange rate forecasting is impossible as all currencies are fairly priced and spot rates reflect all current information and will change in response to "random news." future exchange rates can be forecasted by establishing a relationship between future exchange rates and economic variables that affect future exchange rates with the help of regression analysis. Before making forecasts, it is necessary to consider the factors that can affect nominal and real exchange rate such as structural changes and inflation. Net effective exchange rate (NEER) is a good indicator of the exchange rate of the country. The performance of the NEER makes a good study of the effect of the policies on the exchange rate. Real effective exchange rate (REER) reflects inflation adjusted change in home currency vis-à-vis major trading partners. It reflects major economic indicators. It may be quite possible that one variable is forcing down the value of a currency, another one is forcing it to move up. A market-based forecast can also be applied. Expected exchange rate changes are revealed by market prices when rates are free to reach their competitive levels. The estimation of future exchange rates depends on the spot and forward rates prevailing in the market and on the expectations about the future. Forward rates are considered to be good indicators of expected exchange rates. The advantage of such market-based rates over in-house forecasts is that they are both less expensive and likely to be more accurate. The more clearly and accurately the future trend of foreign exchange can be estimated, the more effectively the plans for managing foreign exchange exposure can be devised into harmony with the overall business objectives.


Identifying Nature of Foreign Exchange
Transaction Exposure
Translation Exposure
Economic Exposure
Analyzing Determinants of
Forces o f Demand & Supply
Political Factors
Psychological Factors
Exchange Rate
Developing Foreign Exchange Exposure
Setting Hedging
Designing Corporate Philosophy for Exposure
Designing Organization for Exposure
Deciding Approaches to Exposure
Setting The Bench Marks & Stop
Evaluation & Selection of Various Exposure Management
Financial
Real
Internal Financial Techniques
External Financial Techniques
Marketing
Strategies
Production
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Exposure Netting
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MODEL OF FOREIGN EXCHANGE EXPOSURE MANAGEMENT

4.4 MEASUREMENT OF FOREIGN EXCHANGE EXPOSURE

The task of gauging the effect of exchange rate changes on an enterprise begins with measuring its exposure to risk, i.e., the amount, or value at risk (VAR). VAR can be defined as the maximum loss on a portfolio, over a standardized period of time. It produces a single currency-denominated figure indicating the risk across many financial instruments and markets on a firm-wide level. Price data relating to the components of a portfolio are collected for specific observation period. Volatilities or standard deviations of assets prices, and correlations between assets prices movements are calculated. Statistical analysis allows the estimation of change in the value of the portfolio in response to changes in the prices of its components, with a certain probability. It also provides a distribution of values for losses or gains that would occur if the current positions were held for a specified holding period. A confidence interval is then applied to the distribution to assess the maximum loss that would be expected, not to be exceeded with a certain probability, thereby determining the value-at-risk of the current portfolio. In other words, this enables management to calculate the likely currency denominated maximum loss for a certain period, and the figure is expressed in terms of a confidence level, usually at 99 %.

A) MEASUREMENT OF TRANSACTION EXPOSURE

Transaction exposure is ever evolving - changing day by day - as business is won, orders are placed, payables paid, receivables received, or cover taken. Companies usually try to determine the net amount of inflows and outflows in each currency and determine the overall exposure to those currencies. For corporate with minimal risk exposure, measurement of transaction exposure may be a very simple process of forecasting what the cash receipts or payments are likely to be for a given period.

Transaction Exposure = (Foreign Currency Inflows - Foreign Currency Outflows) * Expected Exchange Rate

B) MEASUREMENT OF TRANSLATION EXPOSURE

Translation exposure is the difference between exposed assets and exposed liabilities. A greater amount of exposed assets than liabilities will give rise to a positive exposure while a greater amount of liabilities than assets will give rise to a negative exposure. The amount of translation exposure depends on the degree of foreign involvement of a multinational's overseas subsidiaries, the location of these foreign subsidiaries and the correlation between that currency and the home currency and the methods for accounting for the translation.

Translation Exposure = Exposed Assets - Exposed Liabilities

C) MEASUREMENT OF ECONOMIC EXPOSURE

Economic exposure is the extent to which the value of the company (as measured by the present value of its expected cash flows) will change when exchange rates change. There is a major discrepancy between accounting practice and economic reality in terms of measuring economic exposure. Retrospective accounting techniques cannot account for the economic effects of a devaluation/revaluation on the value of a company because these effects are prospective in nature. Financial theory suggests that managers should be concerned with economic reality since managers are assumed to be maximizing the value of the firm. In practice many managers are preoccupied with potential accounting based currency gains or losses. Sensitivity analysis is very helpful in estimating the impact of unexpected exchange rate variations on present value of cash flows of the company.

Economic Exposure = PV of Expected Cash Inflows - PV of Expected Cash Outflows

4.5 DEVELOPING FOREIGN EXCHANGE EXPOSURE MANAGEMENT POLICIES

Every change in foreign exchange rate is not relevant. Since expected changes in exchange rates are usually reflected in forward rates and interest rate, so, from risk management perspective, it is the unexpected deviations from the expected rate that matter. The unexpected exchange rate changes have real effect on the profitability and the value of the firm. Firm should carefully decide whether or not it should indulge in foreign exchange exposure management. Management of foreign exchange exposure should be embraced by the whole enterprise, with participation from all financial chiefs and led by the top management at the broad level. A proper foreign exchange exposure management policy is required to be framed. Now days, corporate are far more conservative with foreign exchange risk management. Quite often they maintain written policies and procedures that clearly outline their exposure management and hedging activities. These policies clearly define the risk tolerance limits and clearly delineate lines of authority and responsibility for managing the risk beyond limits. System should be developed to smell out danger at the earliest stage and quicker decision making to handle it. Coping with risk has always been a challenging task for financial managers. Hedging is not a simple exercise nor is it a concept that is easy to pin down. Having a foreign exchange exposure management system in place will not protect a firm unless it is embedded in a risk aware corporate culture.

4.6 SETTING HEDGING OBJECTIVES

Hedging objectives vary widely from firm to firm, even though it appears to be a fairly standard problem, on the face of it. Companies do not exist in isolation. They compete with other domestic companies in their sector and with companies located in other countries that produce similar goods for sale in the global marketplace. The objective of exposure management can be minimizing costs, maximizing revenue or stabilizing margins in the future. Some of the companies wish to reduce the variability of their income whereas some of them want to improve their competitiveness in the market. All of the companies following hedging policy certainly wish to get protection against adverse happenings by paying certain cost, as low as possible. Few of them wish to hedge all of their exposures whereas many of them are concerned about only their net exposures. But whenever any business unit chooses to hedge its foreign exchange exposure, the main objective is to minimize uncertainty from currency speculation. Some of the companies conduct exposure management on a profit center basis whereas some of them take it on a cost center basis. Companies whose exposures are of long term capital nature can look to manage them on a profit center basis, since the exposures are not open to day to day fluctuations. In this case exposure management is required to generate a net profit. Companies whose exposures are of short term revenue nature should manage them on a cost center basis. The exposure manager would ensure that the cash flows of the company are not adversely affected beyond a certain point. Companies that are the most sophisticated in this field recognize that the financial risks that are produced by their businesses present a powerful opportunity. This level of sophistication depends on the firm's experience, personnel and management approach. It will also depend on their competitors. Firms that have good risk management programs can use this stability to reduce their cost of funding or to lower their prices in markets that are deemed to be strategic and essential to the future progress of their companies. Most importantly, hedging is contingent on the preferences of the firm's shareholders. There are companies whose shareholders refuse to take anything that appears to be financial price risk while there are other companies whose shareholders have a more worldly view of such things.

4.7 DESIGNING CORPORATE PHILOSOPHY FOR EXPOSURE MANAGEMENT

Attitude of a firm towards exposure depends on objective of exposure management of the company. Strengths and weaknesses of firm in terms of finance, production, marketing, human resource, nature of business etc. also affect its strategy to deal with threats and enjoy opportunities offered by external environment. In different business situations, different strategies are suitable. Under the philosophy of low risk and low reward, as soon as the risk arises, it is hedged in the forward market at whatever rates are available. There is very little risk of cash flow destabilization. Under the philosophy of low risk and reasonable reward, there is selective hedging only in case of attractive forward rates. When the exchange rates are not favorable, there is no hedging. The philosophy of high risk and low reward is a policy of leaving all exposures un-hedged. The philosophy of high risk and high reward requires very active trading. Continuous entering into forward contracts, reviewing then from time to time and cancellation of some contracts, if required are some of the policies. It involves not only hedging unfavorable exchange rate movements but also to enjoy the benefits of favorable movements.

4.8 DESIGNING ORGANIZATION FOR EXPOSURE MANAGEMENT

Foreign exchange exposure management can be handled with centralized system or decentralized system. In case of fully centralized system, risk management is the sole responsibility of the corporate center. As a result, it is possible to balance out long and short positions and to calculate the group wide net position for each currency. Only these net exposures need to be hedged in the derivatives markets. The firm can also enjoy the benefits of economies of scale. But it may prove to be too expensive. In case of decentralized system, each corporate unit is responsible for managing its own exposure.

4.9 DECIDING THE APPROACHES TO EXPOSURE MANAGEMENT

Companies' approaches to exposure vary widely. It depends on the nature of the business, the competition or the culture of the company. A company could accept a high degree of risk and expect commensurate returns or it could be very risk averse and be prepared to pay quite a high price for certainty. Indeed it may have no stance on currency at all and take everything as it comes with a 'swings and roundabouts' approach. If a company decides to take an active approach to foreign currency management it will go for hedging. Hedging a particular currency exposure means establishing an offsetting currency position such that whatever is lost or gained on the original currency exposure is exactly offset by a corresponding foreign exchange gain or loss on the currency hedge. Hedging can reduce the company's volatility of cash flows because the company's payments and receipts are not forced to fluctuate in accordance with currency movements. The treasurer's approach will depend on management attitude to risk. The policy in hedging or covering can range from leaving the risk entirely open (0% cover) to a fully covered position (100%).some treasurers believe that foreign exchange rate movements are matched by price movements and will not have any significant impact on cash flows. Such companies do not hedge. Any company which can estimate the future sales revenue fairly accurately may choose to dampen the effects of volatile exchange rates by covering a proportion of a year's expected receipts over a number of preceding years. Some companies will choose to hedge only in those situations in which they expect a currency to move in a direction that will make hedging feasible. These companies hedge their future foreign currency payments when they expect appreciation in the foreign currency. Some companies follow the policy of selective hedging where they issue guidelines to the treasurer on the maximum exposed position or maximum loss. Usually, a proportion of the risk is left to be hedged at the discretion of the treasurer. There can be two approaches for managing foreign exchange exposure. A firm can hedge individual foreign exchange positions with the help of various hedging instruments under micro approach. But in case of multinational companies which are involved in two way cross border activities (exports as well as imports), it is more effective to hedge net positions under macro approach. Net position in a given currency can be derived by subtracting expected cash outflows from expected cash inflows of same time horizon, as it reduces the number and volume of the hedging transactions.

4.10 SETTING THE BENCH MARKS AND STOP LOSS

Market-based forecasts act as a benchmark against which the economic consequences of deviations must be measured. Stop loss policy is immense need of exposure management. In this policy, bench mark is set for exchange rate. This benchmark is carefully decided after giving a due consideration to market trends after providing a certain amount of room for error. When exchange rate moves beyond critical level and the basic assumptions are proven wrong, stop loss policy is to be activated. It means a commitment to reverse a decision when the view is proven to be wrong.

4.11EVALUATION AND SELECTION OF VARIOUS TECHNIQUES

As the change in exchange rate affects the value of the company, it is necessary to manage foreign exchange exposure. The questions arise “what various options are available to business to minimize and manage this risk?”, and “how can they be used effectively to manage foreign exchange risk?” The key to hedging is to decide which of the so many solutions to choose. Hedging is about making the best possible decision, integrating the firm's level of sophistication, systems and the preferences of their shareholders. A hedged position will not only produce the benefit of a favorable exchange rate movement, but it also prevents the hedger from the loss potential of unfavorable exchange rate movements. The underlying principle of a hedging strategy is to construct a portfolio consisting of a long position in the foreign currency asset and a short position in a foreign currency liability in such a way that the gains on one offset the losses on the other. The sheer discipline of keeping a close watch on almost every aspect of world news every day is itself demanding, yet fascinating. The companies that fail to hedge their foreign exchange exposure are exposed to adverse exchange rate movements that may impede its ability to meet its fixed costs.

Firm can use financial hedging instruments or operational hedging techniques. Company can also go for permanent solutions in form of real techniques (operational hedging). Operational hedges offer very powerful strategies for managing foreign exchange exposure. Among the operating policies is the shifting of markets for output, sources of supply, product lines, and production facilities as a defensive reaction to adverse exchange rate changes. It includes diversification, reconstruction and reallocation of resources. It is obvious that such measures will be very costly, especially if undertaken over a short span of time. The technicalities of operational hedges make it impossible to always have a 100% hedge against foreign exchange exposure. Financial hedges may help firms with unbalanced revenue or cost streams, to moderate their exposure. Financial techniques are suited for transaction exposure and operating exposure in short term. Financial hedge is an instrument whose sensitivity to a particular financial price offsets the sensitivity of the firm's core business to that price. There are internal and external financial techniques that can be applied to manage foreign exchange exposure. External techniques include use of currency derivatives like forwards, futures, swaps and options. But hedging is not just about putting on a forward contract. Before going for any of the foreign exchange exposure management strategy, it is imperative to judge its financial feasibility. It is comparative analysis of cost vs. benefits of adopting a particular strategy. Therefore, operating policies designed to reduce or eliminate exposure are undertaken only as a last resort, when less expensive options have been exhausted. It is suited only for managing economic exposure.

4.11.1 INTERNAL FINANCIAL TECHNIQUES

4.11.1.1PRICING DECISION

The firm can use different pricing policy for its overseas exports. Instead of using spot rate into consideration, firm should decide its price by using the forward rates. This policy is based on the rule that value of Rupee received today is not equal to the value of Rupee received tomorrow. In case of subsequence of payments to be received at several points of time, the foreign currency price should be a weighted average of the forward rates for delivery on those dates.

4.11.1.2 CHOICE OF THE CURRENCY OF INVOICING / RISK SHIFTING

Companies engaged in exporting or importing have to take the decisions relating to the currency in which they will invoice their goods and services. Choice of currency for invoicing is a very simple method that can be very helpful for the firm in avoiding exchange rate fluctuations. It can follow the policy of pricing its exports in terms of national currency and making all its payments in home currency. But in case of appreciation of home currency, firm can loose its market share because of its competitors in the market. Firm may opt to select a currency whose fluctuations are less erratic than those of home currency for the purpose of invoicing. Exporters can choose a major currency in which there is an active forward market for various expected maturity periods. Firms may use that currency for invoicing which is being used by the market leader. Whatever may be the case, exporters should try to use a strong/hard currency and importers should use a soft currency for invoicing their international trade. Some firms use ECU for this purpose. It also helps exporters in bringing stability in their pricing policy.

4.11.1.3 CURRENCY RISK SHARING / INDEXATION CLAUSES IN CONTRACTS

Currency risk sharing is a technique where a customized hedge contract is included in the basic trade agreement. It is just like a pricing adjustment. In this method, a neutral zone is decided in advance, which represents the currency range in which risk is not shared. When the exchange rate moves unfavorably beyond this neutral zone, the contract’s Rupee value changes as per predefined terms and total burden of risk is shared by both of the parties.

4.11.1.4 CROSS CURRENCY HEDGE

Where a company deals in such a currency where exposures are extremely vulnerable to sudden drastic moves in currency exchange rates, then it can insulate it from suck shocks by undertaking hedges in the currency other than the dealing currency. The choice of currency would, of course, depend on the trend and forecast for various currencies at that point of time.

4.11.1.5 MATCHING

Matching is a technique whereby a company matches its foreign currency inflows and outflows according to their amount and timings. As a result of matching, management will be able to devise unmatched cash inflows and outflows in foreign currency. The secret of successful management of foreign exchange exposure lies where management is able to bridge the gap between such inflows and outflows and is able to minimize net exposure up to the best possible extent. It requires realistic and accurate predictions of settlement dates. It helps the company in using its foreign currency receipts for making payments in that currency. Company needs to go for currency conversion only for its unmatched transactions. It requires strong information network. Unexpected delays can create problems in matching. Translation exposure can also be managed by matching assets and liabilities in the overseas currency, whenever possible. But this may result in losing control over consolidated gearing. There is also the problem of trying to match assets and liabilities in countries where there are no sophisticate capital markets or in other cases a perfect match is not necessarily desirable. Companies have attempted to solve this problem either by using group currencies and a proxy currency together or using a basket currency.

4.11.1.6 EXPOSURE NETTING

Exposure netting involves offsetting exposures in one currency with exposures in the same or another currency, where exchange rates are expected to move in such a way that losses on one exposed position are to be offset by gains on another position. It is a portfolio approach, which recognizes that the total risk of a currency exposure portfolio should be less than the sum of the individual risk of each currency exposure considered in isolation. Firm should be more considered about its net currency exposure on portfolio instead of worrying about the gain or loss on any individual risk unit. In practice, exposure netting involves one of three possibilities: a firm can offset a long position in a currency with a short position in that same currency, if the exchange rate movements of two currencies are positively correlated, then the firm can offset a long position in one currency with a short position in other currency and if the currency movements are negatively correlated, then short (or long) positions can be used to offset each other. An enterprise can reduce its exchange risk by making and receiving payments in the same currency. In this case, firm is left with only the net exposure which can be further hedged. Netting is possible only if the dates of various receipts and payments in foreign currency match. Netting may be bilateral or multilateral. Bilateral netting is applied in a case when foreign currency transactions occur in between two parties. Multilateral netting is applied when there are numerous internal foreign currency transactions among various groups of the same parent company. It simplifies the funds flow because only the net amount is transferred to the members of the group. It reduces banking costs and increases central control of inter-company settlements.

4.11.1.7 LEADING AND LAGGING

An enterprise can use the policy of leading and lagging for managing its foreign exchange exposure. Leading includes speeding up the foreign currency receipts or payments whereas lagging includes delaying the foreign currency receipts or payments.

TABLE 1

STRATEGIES OF LEADING AND LAGGING

Lagging	Leading
Delay collections of hard currency receivables	Speed up collections of hard currency receivables
Delay dividend and fee remittance to parent and other subsidiaries	Speed up dividend and fee remittance to parent and other subsidiaries
Delay payment of inter-subsidiary accounts payables	Speed up payment of inter-subsidiary accounts payables
Delay payment of accounts payables	Speed up payment of accounts payables
Delay collection of inter-subsidiary accounts receivables	Speed up collection of inter-subsidiary accounts receivables

4.11.1.8 FORFAITING

Forfaiting means surrendering the rights. Exporter can hedge against volatile exchange rates with the help of forfaiting. It means getting the cash realized for the transaction, which is reduced by the agreed discount. Under this technique, importer's bank takes guarantee of importer for payment where importer issues a promissory note to the exporter. Exporter surrenders his right to claim payment for goods or services rendered to an importer in return for cash payment made by forfaiter.

4.11.1.9 DEBT DENOMINATION

A firm with a portfolio consisting only of assets with contractual returns can hedge ("immunize") its value in nominal terms by the way of appropriate use of currency for debt denomination. But an enterprise whose assets yield, for the most part, non-contractual returns cannot hedge its exchange risk perfectly. A given exchange rate change has a different effect on the return of non-contractual assets than return on contractual liabilities. Firm can select between direct or indirect debt denominations. Managers have to be very careful in making their decision on the trade-off between arbitrage gains and exchange risk stemming from exposure. Debt denomination brings this residual exchange risk up to reasonably small level.

4.11.1.10 SPOT HEDGE/ MONEY MARKET HEDGE

A money market hedge involves simultaneous borrowing and lending activities in two different currencies to lock in the Rupee value of future foreign currency cash flows. It requires a loan contract and a source of funds to carry out that contract. If a firm is to receive in future an amount denominated in foreign currency, it can borrow foreign currency equal to present value of the amount of foreign currency and convert it to home currency at spot rate and thus hedge the exposure. Firm can deposit it with bank. When in future it will receive foreign currency amount, it can use that amount to repay its foreign currency borrowings. On the other hand to hedge future foreign currency payment it can determine present value of foreign currency required in future. Then it can borrow that amount of foreign currency at current spot market and use it in future to meet its foreign currency obligations. The cost of the money market hedge is determined by differential interest rates.

4.11.1.11 FOREIGN CURRENCY ADVANCES

Foreign currency advances can provide protection to exporters and importers against unfavorable exchange rate movements. Exporter can surrender the foreign exchange to the bank at the spot rate and receive Rupee in advance. Advances in foreign currency are even more beneficial for exporters if the rate of interest on the foreign currency happens to be lower than that on credits in Rupee.

4.11.1.12 FUNDS ADJUSTMENT

Funds adjustment involves altering either the amounts or the currencies (or both) of the planned cash flows of the parent company and/or its subsidiaries in order to reduce the firm's local currency accounting exposure. If local currency devaluation is anticipated, exports are priced in hard currencies and imports are priced in the local currency, investing in hard currency securities and replacing hard currency borrowings with local currency loans. It is a defensive approach whereby a firm tries to increase its exposed cash inflows denominated in currencies expected to be strong or increases cash outflows denominated in weak currencies. Firm also tries to reduce exposed borrowings and trade creditors in strong currencies and reducing cash, debtors and loans receivables in weak currencies.

4.11.1.13 BALANCE SHEET HEDGE

Balance sheet hedge includes management of foreign exchange exposure in such a way that net asset exposure comes to be zero. It can be done by making remittances or making payment against payables etc. The amount of assets and liabilities can be denominated in a particular foreign currency for this purpose.

4.11.2 EXTERNAL FINANCIAL TECHNIQUES

4.11.2.1CURRENCY FORWARD CONTRACTS

Currency forward is an agreement to exchange a specific quantity of a specific currency for another currency on a specified future date at an agreed forward rate. Forward rate is a price for foreign currency set at that time when the transaction is agreed to but the actual exchange or delivery takes places at a specified time in the future. Forward are usually used to obtain cover on future foreign currency receivables and payables. Only at maturity, a forward contract is settled by delivery of the asset by the seller to the buyer in return for payment of the contract price. The amount of the transaction, the value date, the payment procedure and the exchange rate are all determined in advance. Sometimes instead of fixing one date, settlement of contract is allowed during a specified period of time in the future. The start and end date for exercising such type of option for settlement of contracts is always specified while entering into the contract. These are usually known as time option forward exchange contracts. These contracts are very much useful to cover receivables and payables when the exact date of such transactions either is not fixed or not known. These are for any amount, as long as it's big enough to be worth the dealer's time. These are traded by phone and telex and are completely independent of location or time. A company can enter into forward contracts based on its exposure. A net asset exposure will require forward sale of exposed currency and a net liability exposure would require a forward purchase. A company that is in long position of a foreign currency will sell the foreign currency forward, whereas a company that is in a short position of a foreign currency, will buy the foreign currency forward. The hedge may disappear when one party is unable to perform on the contract and it may result in huge cost to the hedger.

4.11.2.2CURRENCY OPTION CONTRACTS

Currency option is an agreement where the option holder has the right to buy (or sell) one currency in exchange of another currency at an agreed price, on or before the agreed date but has no corresponding obligation. For this option holder pays option premium. The option seller receives the premium and is obliged to make (or take) delivery at the agreed price when buyer exercises his option. Call options give the holder the right to buy foreign currency, while put options give the holder the right to sell foreign currency. If the exchange rate doesn't reach a level at which the option makes money prior to expiration, it expires worthless – unlike forwards and futures, and the holder of an option does not have an obligation to buy or sell if it is not advantageous to do so. The exchange rate, currencies, amount and date are determined at the time of entering the contract. Options can be of two types; American option or European option. American option permits the holder to exercise the option at any time before the expiry date; European options can be exercised only on the expiry date. It also offers a range of prices where the option can be exercised. The maturity of option can be one, three, six, nine or 12 months. This maturity can lie in March, June, Sep. and Dec. Options are ideal for hedging contingent cash flows which may or may not materialize. These provide the best tools to hedge balance-sheet translation exposures. In analyzing an option strategy there are a number of important considerations such as: the cost of the strategy, portfolio manager's opinion of the market, time frame, volatility level of option and expected frequency of use for each strategy. In over the counter, options are tailored to the client's needs whereas in case of exchange traded contracts, size of contracts cannot be adjusted as it is standardized. Now days, another market currency futures options market is also available where contracts are mixture of currency futures & options. In this market, options are marked to market basis- daily settlement.

4.11.2.3CURRENCY FUTURE CONTRACTS

Currency future is an agreement to exchange a standardized quantity of a specific currency for another currency on a specified future date at future price on the floor of an organized future exchange as per the terms of the stock exchange. These contracts are traded in specific sizes. The counter party to futures contracts is a clearing house of the stock exchange, which ensures that all contracts will be honored. This effectively eliminates the credit risk to a very large extent. These contracts are marked to market on daily basis. The gains or losses on the futures contract are settled in cash. If the futures price increases, the holder receives the difference between yesterday's price and today's price from the futures exchange. If the futures price decreases, the daily difference is deduced from the margin in the holder's trading account. The sum of all daily gains and losses will equal the net change in the futures price over the life of the contract. One should take a reverse position on the futures market as compared to the position that one has on the spot market. Purchase of a currency future protects against an appreciation on the currency of contract. Similarly, sale of a currency future contract protects against a depreciation of the currency of contract.

4.11.2.4 CURRENCY SWAP CONTRACTS

Currency swap is an agreement between two or more parties to exchange principal and interest obligations/receipts, for an agreed period, between two different currencies, and re-exchange principal amounts on maturity at an agreed exchange rate. Currency swaps can be defined as a legal agreement between two or more parties to exchange interest obligation or interest receipts between two different currencies. A basic currency swap is the simultaneous purchase and sale of one currency for another, where the two contracts have different dates (different positions of same or different amount on different dates). Borrowers in today’s markets have a variety of ways of raising money. In some cases a company may be unable to raise capital in a certain currency. These swaps allow companies to exploit the global capital markets more efficiently. These give companies extra flexibility to exploit their comparative advantage in their respective borrowing markets. Usually, the companies receive more favorable credit ratings in their country of domicile than in the country in which they need to raise capital. In this case, there is exchange of currencies due to the fact that one counter party is able to borrow a particular currency at a lower interest rate that the other counter party is able to borrow. With the help of a swap dealer usually a bank, both the parties exchange the currency borrowed by them from the market and get the desired currency. They will fully hedge their foreign borrowings by means of a foreign exchange swap transaction in much the same way investors hedge their foreign fixed income investments. Currency swaps are used to exchange assets or capital in one currency for another. Currency swaps are also used to lower the risk of currency exposure or to change returns on investment into another, more favorable currency. These contracts help in minimizing foreign exchange exposure by offsetting the particular cash flow stream with an opposite flow in the same currency. Currency swap can take any form such as accreting swap, amortizing swap, basis swaps, forward-forward swap, forward-start swap, interest rate swaps, multiparty swap, parallel loans, callable swap, cross currency coupon, currency swap, currency protected swap, off market swap, plain vanilla swap or zero coupon swap. With the help of swaps, companies can exploit advantages across a matrix of currencies and maturities. But because of the exchange and re-exchange of notional principal amounts, the currency swap can generate credit exposure, which should be duly considered while using swaps.

4.11.3 REAL STRATEGIES

The appropriate response to an anticipated or actual real exchange rate change depends crucially on the length of time that real change is expected to persist. A longer lasting change in the real exchange rate will definitely induce firm to take major long term decisions for their permanent management. As different exchange rates are not perfectly correlated, a firm can also reduce foreign exchange exposure impact by diversifying cash flows over different currencies. In fact, operational flexibility enables the firm to selectively exploit favorable currency movements to maximize profit potential and minimize the impact of adverse currency movements and downside risk. MNCs with their concentrated networks in a few countries are not capable of effectively reducing their currency exposures. MNCs with greater breadth of operations are better equipped to effectively manage their foreign exchange exposure. Competitive advantage is based on expertise in the areas like production, marketing, the organization of people, or technical resources.

4.11.3.1 MARKETING STRATEGIES

A) MARKET SELECTION

Market selection is very crucial decision. Where to sell and where not to sell is critical for any exporter as it will definitely affect its foreign exchange exposure. It is also significant to decide the relative marketing support to devote to each market. Firm has to be very careful about its target market. A firm that sells differentiated products to more affluent customers may not be harmed as much by a foreign currency devaluation as will a mass marketer. On the other hand, in case of depreciation of home currency, a firm selling primarily to upper income groups may find it easy to penetrate mass market abroad. Marketing mix should be designed in such a way that it can be adjusted over a period of time if required to manage its foreign exchange exposure.

B) ABANDONING FOREIGN MARKETS

When an MNC is facing a situation of low prices on outputs, high costs of inputs, or lack of competitiveness in the market relative to other producers, it can use its ability to abandon foreign market, but it may result in hurting customer relationship and huge re-entry expenses if firm hopes to return in future.

C) PRICING STRATEGY

Flexible pricing strategy can be very helpful in managing foreign exchange exposure. By changing its pricing policy, an MNC has ability to vary the level of foreign exchange exposure. All the fluctuations in exchange rate can affect only foreign currency sales prices. In this policy, an MNC accommodates its cost in the profit margin. MNC can also follow a policy of domestic currency sales pricing. While this fixes the profit margin, sales price and volumes will fluctuate with production costs. As a result the level of sales is protected, but the domestic currency profit margin will vary with the exchange rate and production costs.

In case of Rupee appreciation, an exporter can recoup Rupee profits by raising foreign currency selling price by the extent of the foreign currency devaluation. In case of Rupee depreciation, Indian exporter will enjoy competitive advantage in the world market. Exporter can now increase its profits by increasing its Rupee prices. With the help of its pricing strategy firm is able to exploit the beneficial foreign currency appreciations and cost decreases if demand is elastic. But before taking any such decision, the factors like elasticity of demand, customer price sensitivity, existence of economies of scale, cost structure of expanding the output and likelihood of attracting competition etc. must also be considered.

D) PROMOTIONAL STRATEGY

Promotional budget and its allocation among various countries is very significant decision for managing foreign exchange exposure. A firm exporting its products after a domestic devaluation may well find that the return per Rupee expenditure on advertising and selling has increased because of the product's improved price positioning. In case of foreign currency devaluation, return on marketing expenditures is likely to reduce which may require a firm to bring a more fundamental change in firm's product policy.

E) PRODUCT STRATEGY

Product strategy can be very helpful in responding to exchange rate exposure. Firm can change the timing for introduction of new products. It can also take product line decisions. In case of home currency depreciation, firm has potential to expand its product line and cover a wider range of customers both in domestic market and foreign market. Firm may concentrate on developing a brand franchise to enjoy the benefits of competitive prices. On the other hand in case of home currency appreciation, a firm may have to reorient its product line and target its product to a higher income, more quality conscious and less price sensitive customer group.

4.11.3.2 PRODUCTION STRATEGIES

A) INPUT MIX

Firms with high imports and high involvement in international trade will be effected more by any change in exchange rates as compared to the firms having low import component and low involvement in international trade. They may choose more flexible input mix in overseas market. In case of appreciation of domestic currency, firm may increase its global sourcing. When the suppliers are faced with an exchange rate exposure which reduces the competitive prices of their output, they are able to reduce their cost and remain economically viable because of their cheaper input mix.

B) EXPLOIT INTER AND INTRA COUNTRY NEW PRODUCT GROWTH OPTIONS

A firm with worldwide production system can allocate its total production over its various production plants in the line with changing Rupee cost of production. It enjoys more options to expand its product line and introduce new products in foreign countries. Firm may follow the strategy of globally balanced production facilities in order to manage its currency exposure. It can follow the policy of increasing the production in a country whose currency has devaluated and decreasing the production in a country whose currency has appreciated. Though shifting the production is not so easy task and multiple plants can crate manufacturing redundancies and impede cost cutting yet there are many advantages of diversification in case of exposure.

C) PLANT LOCATION

Depending on the labor intensity of production or expected cash flows, a firm can also go for third country plant location. It is a long term capital decision. Firm should consider all the possible factors before going for such kind of production strategy. Sometimes it may create the problems of coordination between design and manufacturing and may result in problems of quality control.

D) RAISING PRODUCTIVITY

Many firms find it more suitable to increase their domestic productivity as compared to producing abroad. It can do so by closing its inefficient production plants, automating heavily, and reducing its other overheads. Firm can also follow the policy of employee motivation to heighten its productivity and improve its product quality.

4.11.3.3 DIVERSIFIED FINANCING

A company can make change in its financing policies to manage its exchange rate exposure. It can bring changes in the currency of denomination used for the purpose of long term debt, place of issue, maturity structure and capital structure and leasing versus buying strategy. Diversified financing sources allow the company to improve its overall financial performance because interest rate differentials do not always equal expected changes in exchange rates. Companies are also able to reduce their economic risk by matching the mix of currencies in loan portfolios or operating expenses to the mix of currencies in expected revenues.

4.11.3.4 IMPLEMENTATION AND REVIEW

Managing foreign exchange exposure involves prudently managing mismatch positions and exchange rate exposures in order to control, within set parameters, the impact of changes. Before engaging in hedging activities, management should ensure that all appropriate approvals are obtained and that adequate operational procedures and risk control systems are in place. Management must also ensure that hedging activities are allocated sufficient resources and staff to manage and control risks. It includes establishment and review of appropriate market controls, policies and procedures. Exposure management can be successful only when all the personnel involved in exposure management have a complete understanding of the risks associated with all of the hedging activities. Continuous monitoring is essential to see whether or not exposures are headed where they are intended to reach. It is necessary to compare profitability vis-à-vis benchmarks. The process of measuring, monitoring and controlling exposure has to be consistent with the established policies and procedures. Proper communication system is essential for regular reporting and re-evaluation of significant exposure management policies and procedures.

5. CONCLUSION

The effect of currency movements on the profitability of the company is obviously very important. Continuous fluctuations in exchange rate impose threats for international business.

Foreign exchange exposure not only affects firm's financial position but also its competitive position in the market and value of firm. Bimal Jalan said "exchange rate fluctuations among major currencies are now an everyday fact of life and it is important for all entities with foreign exchange exposure to resort to hedging with appropriate risk management of assets and liabilities". For a multiunit, multi-product, multi-national corporation, the net exposure may not be very large at all because of the many offsetting effects. In contrast, enterprises that have invested in the development of one or two major foreign markets are typically subject to considerable fluctuations of their net cash flows, regardless of whether they invoice in their own or in the foreign currency. The same holds for those that are exposed to competition from dominant foreign rivals. At some level or the other, the currency fluctuations may threaten the firm's viability. In the words of G. V. Rao "Risk management's functions, if neglected, do not immediately threaten the performance of an enterprise, unless a disaster strikes. Even if a firm opts to invoice its export in home currency, it will have to adjust its price if value of foreign currency fluctuates, otherwise it would not be able to survive in an era of cutthroat competition. Further he said, "Anything that costs money to remedy, or that does not compel attention gets overlooked, unless it grows into a disaster." The benefits of foreign exchange exposure management should be viewed, not in terms of savings in costs being incurred currently, but more in terms of potential savings in costs that are compulsory to be incurred and preventing the occurrence of those events that can threaten the organizational health. Organizations without real time reporting and a risk aware culture may be slow to react to changing patterns of risk exposure and loss. J. E. Bannister said, "Complete elimination of risk could, of course pose us a server philosophical and practical problem in the elimination of uncertainty". Ignoring foreign exchange exposure when it cries of attention, may lead to serious problems at a subsequent date.

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