UNIT 10 MANAGEMENT OF EXCHANGE RISKS

Structure

10.0 Objectives
10.1 Introduction
10.2 Meaning and Nature of Exchange Rates
10.3 Types of Exchange Rate
- 10.3.1 Spot Rate
- 10.3.2 Forward Rate
- 10.3.3 Distinction between Spot and Forward Rates
- 10.3.4 TT (Telegraphic Transfer) Rate
- 10.3.5 Bill Rate

10.4 Identification and Measurement of Exchange Risks
- 10.4.1 Risk as an Exporter
- 10.4.2 Risk as an Importer

10.5 Methods of Dealing with Foreign Exchange Risks
- 10.5.1 Forward Contracts
- 10.5.2 Currency Options
- 10.5.3 Cancellation and Extension of Forward Contracts

10.6 ECGC Schemes for Covering Exchange Risks
10.7 Let Us Sum Up
10.8 Key Words
10.9 Answers To Check Your Progress
10.10 Terminal Questions

10.0 OBJECTIVES

After studying this unit, you should be able to:

- explain the meaning of exchange rate;
- describe various types of exchange risk;
- discuss the measurement of exchange risks; and
- explain the methods of dealing with foreign exchange risks.

10.1 INTRODUCTION

You have learnt about export credit insurance in Unit 9. As you know, export business involves exchange of currency of one country for that of another country. This conversion is necessary for the proper movement of goods and services across national frontiers. During the transaction period, the value of currency may appreciate or depreciate. This fluctuation may result in loss or gain to the exporters or importers. In this unit, you will learn the meaning and various types of exchange rates. You will also learn the methods of dealing with foreign exchange risks.

10.2 MEANING AND NATURE OF EXCHANGE RATES

During the Great Depression of the 1930s, almost all countries found it difficult to increase their exports. Many of them decided to resort to repetitive devaluation of their currencies. Devaluation means lowering the value of its currency by a country in terms of other currencies. By doing so, a country attempts to make its goods cheaper in foreign markets thus encouraging its exports. On the other hand, foreign goods are made expensive in the domestic markets which tends to discourage imports. One of the objectives of the International

Monetary Fund established in 1947, was to "promote exchange stability, to maintain orderly exchange arrangements among members and to avoid competitive exchange depreciation". Thus it was envisaged that the exchange rates of various currencies would remain more or less stable. Under the provisions of the IMF, every country was required to declare the par value of its currency in terms of gold or dollars. Gold was valued at $35 per ounce, the country was supposed to maintain the value of its currency within a margin of ± 1% of the par value. Thus the foreign exchange risk, -if any, was limited and the problem was not serious. After August 1971, this margin was increased to ± 2.25 per cent - and by March 1973, the system of fixed par values was virtually given up. And at present, the value of the major currencies continues to fluctuate with the result that the problem of foreign exchange risk has assumed serious proportions. An idea of the fluctuations in par values can be had from the following examples: The value of the rupee to a US dollar was Rs.9.14 in 1976, Rs.8 in 1980, Rs.12.50 in 1985 and Rs.36.35 in 1997. The wider the fluctuations in exchange rates, the more is the risk involved.

Definition of Exchange Rate

A foreign exchange rate is simply the price of one country's money in terms of another country's money. In other words, **the rate at which one country's money or currency buys or exchanges for another country's money or currency is known as the rate of exchange.** And foreign exchange is the mechanism by which the currency of one country gets converted into the currency of another country.

Individuals and firms normally do not buy and sell foreign currencies for their own sake but in the process of buying and selling something else - a product, a service or a financial asset. In this sense, foreign exchange transactions are fundamentally a part of the payments mechanism. Again, it connects the price system of two countries whose currencies are involved in an exchange rate. For example, suppose one rupee exchanges for 3 pence of the English currency. It means in effect, that what one rupee can buy in India, 3 pence can buy in England. Therefore, by converting a rupee into pence, an Indian can buy 3 pence worth of goods in England, not directly, but indirectly through buying the British currency first and goods and services later.

Now let us see how this conversion takes place. The prospective importer of British goods would approach a bank which is authorised to deal in foreign exchange. The bank would issue a draft payable in British pounds on its branch or its correspondent bank in the U.K in exchange for equivalent value plus its charges. The importer would then send this draft to the exporter who can encash it at the bank on which it is drawn. An exporter of Indian goods would similarly approach a bank for selling the foreign currency draft received by him and to receive the equivalent sum in Indian rupees minus the bank charges. Thus foreign exchange transactions are very conveniently handled by banks.

10.3 TYPES OF EXCHANGE RATE

Exchange rates may be either spot rates or forward rates. Let us discuss them in detail.

10.3.1 Spot Rate

The current exchange rate is usually the spot rate. It is the rate at which most foreign exchange transactions are carried out. If the contract to buy or sell foreign currency is agreed upon and executed immediately, the transaction is known as a spot transaction and the rate quoted is the spot rate. By convention, the agreed payment date or 'value date', as it is known is usually two business days after the transaction has originated. The two day period gives ample time for the two parties to send the instructions necessary to debit and credit bank accounts here and abroad.

Direct and Indirect Rates

The exchange rate may be quoted in either of the following ways:
i) US$1 = Rs.35
ii) US$2.857 = Rs.100

In the first method, the rate of exchange is expressed for a fixed unit of foreign currency. The difference in the rate is expressed by a variation in the home currency, viz., the rupee. Such a method **where the unit of foreign currency is kept constant and price variation is reflected in the units of home currency is known as 'direct' or 'home currency' quotation.**

In the second method, the rate of exchange is expressed for a fixed unit of home currency. The difference in the rate is expressed by a variation in the foreign currency. Such a method, **where the unit of home currency is kept constant and price variation is reflected in the units of foreign currency is known as 'indirect' or 'foreign currency' quotation.**

In India, banks were required to quote all the rates on indirect basis till August 1, 1993. Exceptions were the sale/purchase of foreign currency notes and traveller cheques where exchange rates on direct quotation were used. **From August 2, 1993 banks are quoting rates on direct basis only.**

Buying and Selling Rates

In foreign exchange transactions, the exchange quotation will have two rates. One at which the bank is willing to buy and the other at which the bank is willing to sell. The rate at which the bank is willing to buy is known as **buying rate** or **bid rate** and the rate at which it is willing to sell is known as **selling rate or offer rate**. There is always some difference between buying and selling rates. This happens because foreign exchange dealer would like to make profit from the exchange transactions. Let us take an example of direct quotation. The Authorised dealer buys at US$1 = Rs.35.3675 and sells at US $1 = Rs.35.3725. The dealer buys at lower rate and sells at a higher rate. You should note that **in direct quotation, the authorised dealer buys at a lower rate and sells at a higher rate.**

Let us take another example, when a dealer in India buys foreign currency he pays less units of the local currency against every one unit of the foreign currency. When he sells foreign currency, he receives more units of the local currency against everyone unit of foreign currency. Let us say that the dealer quotes a spot dollar rupee rate of US$1 = Rs.35.3625 - Rs.35.3675. This means that the dealer is willing to buy dollar at Rs.35.3625 per unit of dollar and sell dollar at Rs.35.3675. This also means that the dealer is willing to sell rupees at Rs.35.3625 per unit of dollar and buy rupees at Rs.35.3675 per unit of dollar. As you have noticed, there is a difference between the buying rate and the selling rate. This difference is termed as **spread.** Hence, spread refers to the difference between the buying rate and the selling rate in an exchange rate quotation or an interest quotation. It fluctuates according to the level of stability in the market and the volume of business.

10.3.2 Forward Rate

The rate quoted for delivery of foreign exchange in future at some agreed date, i.e., when the value date is more than two business days in future, is called the forward rate. A forward bank enters into a contract to buy/sell a fixed amount of foreign currency at a specified future date at a predetermined rate of exchange. The rate quoted for the transaction is the forward rate. The date of delivery of foreign exchange in future or the maturity of a forward foreign exchange contract can be a few days, months or years in some cases. The exchange rate is fixed at the time the transaction is agreed upon. But no money actually changes hands until the maturity date. There will be a specific exchange rate for each forward maturity and each of these rates almost always will differ from today's spot exchange rate.

Forward Quotations

Forward rates can be expressed in two ways. Commercial customers are usually quoted the actual price which is referred to the **outright rate.** On the other hand, in the interbank market, dealers quote the forward rate only as a discount from, or a premium on the spot rate. This forward differential is known as the **swap rate.**

If the forward exchange rate for a currency is higher than the current spot rate, it is said to be trading at a premium for that forward maturity. If the forward rate is below the spot rate, then the currency is said to be trading at a discount. If the forward rate is the same as the spot rate, then it is said to be at par with the spot rate but it happens only rarely.

10.3.3 Distinction between Spot and Forward Rates

You have learnt what are spot and forward rates. Let us now explain the distinction between both rates. Spot rates are applicable on the day of transaction. Forward rates are the rates fixed in advance for a transaction which will mature at a specified date or during a specified period in future. Quotations for spot rates are generally available. For forward rates, customers have to enter into specific contracts. Forward rates would more often be at a premium or at a discount as compared to spot rates.

10.3.4 TT (Telegraphic Transfer) Rate

Telegraphic Transfer rate may be either TT buying rate or TT selling rate. Let us discuss them in detail.

T.T. Buying Rate: This rate is applied for purchase of foreign currency by banks where cover is already obtained by banks in India. This rate is applied for all clean remittances outside India. All foreign inward remittances which are made payable in India are converted by applying this rate. For example, suppose Nisha gets from Citi Bank in New York a demand draft for $10,000 drawn on Citi Bank, New Delhi. The New York bank will credit the New Delhi Citi Bank's account with itself immediately.

TT buying Rate is calculated as :
TT Buying Rate = Base rate - Exchange Margin.

The base rate refers to the inter bank rate. The foreign Exchange Dealers Association of India (FEDAI) has prescribed exchange margin rate as between 0.025% to 0.080%. Banks have discretion to charge any rate of exchange margin within this prescribed range. Let us take an example.

Suppose interbank rates for US $ are:
Spot US$1 - Rs.35.2575 - 35.2625

This means that Base Rate	=	35.2575
Less Exchange Margin @0.08%	=	0.0280
		35.2295

Round off Figure = 35.23

Suppose a customer wants to purchase a draft drawn on New York for $10,000. The customer will have to pay (35.23 x 10,000) = Rs.3,52,300. The bank may charge commission.

T.T. Selling Rate: This rate is applied for all clean remittances outside India. It is applied for selling foreign currency to its customer by the bank such as for issuance of bank drafts, mail/ telegraphic transfers, etc. The rate is computed as:
TT Selling Rate = Base Rate + Exchange Margin

Here, the base rate is the interbank selling rate. FEDAI has prescribed exchange margin rate for TT Selling rate as between 0.125% to 0.15%.

Let us take an example.
Interbank exchange rate for US $ is:

Spot US$1	=	35.2625
Add Exchange margin say 0.15%	=	0.0528
		35.3153
Round off Figure	=	35.32

Suppose a customer wants to purchase a draft drawn on New York for $10,000. The customer will have to pay (35.32 x 10,000) = Rs.3,53,200. The bank may charge commission.

10.3.5 Bill Rate

Bill rate may also be either bill buying rate or bill selling rate. Let us discuss them in detail.

i) **Bill Buying Rate:** This rate is applied when a foreign bill is purchased. As you must be knowing that exporters draw bills of exchange on their foreign customers. They can sell these bills to an authorised dealer for immediate payment. The authorised dealer buys the bill and collects payment from importer. When the bill is purchased, the proceeds will be realised by the authorised dealer after the bill is presented to the drawee at the overseas centre. In case of sight bill the payment is made on presentation of the bill. In the case of usance bill, the proceeds will be realised on the due date of the bill which includes the transit period and the usance period of the bill. The bank or the authorised dealer, therefore, makes an allowance for the loss of interest for the period of transit, the usance of the bill and the days of grace, if any. The authorised dealer loads the forward margin for an appropriate period. The period for which forward margin is to be loaded depends upon whether the foreign currency is at a forward premium or discount. The authorised dealers extract the rate which is most favourable for them. The rate is computed as:

Bill Buying Rate = The base rate - Forward discount for transit plus usance period rounded off to the higher month - Exchange Margin

or

Bill Buying Rate = The base rate + forward premium for transit plus usance period rounded off to the lower month - Exchange Margin

FEDAI has prescribed exchange margin rate as between 0.125% to 0.150%

ii) **Bill Selling Rate:** This rate is applied for all foreign remittances outside India as proceeds of import bills payable in India. In this case the importer requests the bank to make payment to a foreign supplier against a bill drawn on the importer. The bank handles documents related to the transaction. For this purpose, the bank loads margin over the TT selling rate. It is computed as:

Bill Selling Rate = TT Selling Rate + Exchange Margin

FEDAI has prescribed exchange margin rate as between 0.175% to 0.200%.

Check Your Progress A

1. What do you mean by Exchange Rate ?

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2. Distinguish between spot rate and forward rate.

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3. State whether the following statements are True or False.
   i) The current exchange rate is usually the forward rate.
   ii) If the unit of home currency is kept constant and price variation is reflected in the units of foreign currency, this is known as direct rate.
   iii) The rate at which the bank is willing to buy is known as bid rate.
   iv) If the forward exchange rate for a currency is higher than the current spot rate, the currency is said to be trading at a discount.
   v) Bill selling rate is slightly less favourable to the customer than the T.T. Rate.

10.4 IDENTIFICATION AND MEASUREMENT OF EXCHANGE RISKS

In foreign trade, you may be either an exporter or an importer. Let us now examine what is the exchange risk to which an exporter or an importer is exposed.

The exchange risk arises because there is a time gap between the shipment of goods and the receipt or payment of the price thereof. And the exchange rate of the currency involved may

undergo a change in the time period involved. If you are an exporter, you receive less rupees than you expected. If you are an importer, you might have to pay more than what you bargained for. Let us first see the position as an exporter.

10.4.1 Risk as an Exporter

You may draw your export bills either in rupees or in foreign currencies. If you have drawn your export bills in Indian currency i.e., rupees, you will not suffer any loss by any possible depreciation of foreign currencies or of Indian rupees. You are sure to receive the Indian rupees for which you have invoiced your goods. But it may not always be possible for you to invoice your goods in rupees. Firstly, the foreign importer may insist that he be billed in his local currency. That will make the cost of goods imported by him certain in his own currency. Again, it is a matter of courtesy to the exporter to bill the importer in the currency of importer's choice. It is a good marketing strategy also. Moreover, the Government of India has now directed that exporters bill their importers in foreign currency only.

If you have billed your importer in a foreign currency, there is an equal possibility that the foreign currency may appreciate or depreciate by the time you are likely to receive payment. As a result, you may receive more or less in terms of rupees than you bargained for. Let us understand this by means of an example. Suppose you export goods worth US$10,000 on January 1, when the value of $1 is Rs.35. You thus, expect a payment of Rs.3,50,000. But the payment is due to be received by you on May 1. Suppose the value of the dollar decreases to Rs.34 on the day. You will now receive only Rs.3,40,000. The fact that Indian exporters operate on a very low margin, may mean that whatever profit he expected may be wiped out due to a decline in the value of the dollar. But if the value of the dollar increases to Rs.36, the exporter will get Rs.3,60,000 and may earn a profit that he never expected. Thus while there is a possibility of the exporter making a windfall profit, there is a definite risk to which the exporter is exposed. The larger the depreciation of the foreign currency, the larger is the risk to which the exporter is exposed.

10.4.2 Risk as an Importer

The position is entirely opposite of what it is for the exporter. If the importer is billed in rupees, he does not stand to loss at all whether the foreign currency appreciates or depreciates. But considering the position of the Indian rupees as it is, no exporter would like to bill the Indian importer in rupees. Hence, the importer is always exposed to an exchange risk. Let us suppose that an Indian importer contracts to purchase an equipment costing $10,000 on January 1, expecting to pay Rs.3,50,000 in Indian currency. But if the value of dollar increases to Rs.36 on May 1 when the payment is due, he will have to pay Rs.3,60,000 and not Rs.3,50,000. Of course, there is an equal possibility of the dollar going down to Rs.34. In that case, the Indian importer will stand to gain. But the point is that he is exposed to a risk. The higher the appreciation of the dollar the higher is the risk to which he is exposed.

10.5 METHODS OF DEALING WITH FOREIGN EXCHANGE RISKS

A firm can deal with foreign exchange risks in the following ways:

1) **Taking Risk:** The firm may decide to bear the risk if the foreign currency depreciates or appreciates and pocket the gain resulting therefrom. Bigger firms having both imports and exports can match the losses and gains on exports with gains or losses on imports. Matching will ultimately minimise the losses and gain if any. Matching is easier in a large diversified firm than in a firm dealing in one product only. Large trading houses and export houses as also STC and MMTC can do it easily. An important point to be mentioned here is that losses and gains due to exchange fluctuations are taken into account for tax purposes. Thus assuming that the rate of tax is 50 per cent, the impact of losses due to exchange fluctuations, if any is reduced to 50 per cent only.

2) **Using a Hedging Clause:** The exporter can use a hedging clause in the contract with the customer/supplier providing for a revision of price in the event of a significant change. This will tend to protect both parties as movement in exchange rates may both be the upwards and downwards. While you protect yourself against a loss, you lose the

possibility of making a profit. However, the customer/supplier may not agree for such a clause in short-term agreement. But it is more easily possible in long-term contracts.

3) **Entering into Forward Contract:** Forward contracts are deals between two parties who enters into the contract for buying or selling of the foreign currency at a future date. The firm can enter into a forward contract with his banker. If it is an importer, it can purchase foreign currency to be delivered in future (forward purchase). If it is an exporter, it can sell foreign currency to be delivered in future (forward sale). This will ensure that the firm receives or pays a certain amount of rupees irrespective of changes in the value of foreign currency involved.

10.5.1 Forward Contracts

As you have learnt that entering into forward contract is one of the important method of dealing with the foreign exchange risk. Let us also remind you that in forward contracts two parties enter into the contract for selling or buying of foreign currency in future.

The banks are willing to provide forward cover for the risks arising out of fluctuations in exchange rates to both the importers and exporters. Let us understand it with the help of an example. If the exporter expects to receive, say, dollars after three months, he can approach his banker to purchase dollars forward for him at the forward rate prevailing on the day of the contract. This way he will ensure his export proceeds in terms of rupees. Of course, he will lose possible benefits of any appreciation of dollar by so covering his risk. But the exporter is basically interested in making a profit on exports and not a profit on fluctuations in exchange rates which is the business of speculators in foreign exchange.

Similarly, an importer expecting to make a payment, say, in dollars after three months, can approach his banker to sell him dollars forward at the forward rate prevailing on the day of the contract. This way he will ensure the rupee cost of his imports. Of course, like an exporter, he will lose possible benefits of a reduction in his cost due to depreciation in dollars.

Forward contracts do have a cost. The banks will charge some commission. In addition, they will take into account the premium or discount the forward rate has over the spot rate. Again, a forward contract is a contract which has to be fulfilled by delivering or purchasing the foreign exchange from the bank exactly at the due date. In case it is not done, the exporter/ importer will have to pay penalty/compensation to the bank.

The banks, however, allow the exporter to have an option forward contract in place of a fixed forward contract. In fixed forward contracts, foreign exchange has to be delivered on the fixed day. In real situations, it may not be possible to do so. At best, you can estimate the probable date. To obviate this difficulty, the customer may be given a choice of delivering foreign exchange during a given period of time. This is called an option forward contract. Rate is known as the option forward rate period is known as option period. Let us discuss them in detail.

10.5.2 Currency Options

As you have learnt the forward contract protects the interest of the holder against the risk of adverse movements in exchange rates. At the same time, the contract eliminates the possibility of gaining a windfall profit from favourable movements. This led the commercial banks to introduce the Currency Options. In currency options or option forward the rate of exchange between the two currencies is fixed at the time the contract is entered into as in a forward contract but the delivery date is not fixed. What is an Option ? An option is a financial contract that gives the holder the right but not the obligation to sell or buy the financial instrument at a set price and expiration date. When holder has the right to sell the financial instrument, it is termed as put option. On the other hand, when the holder has the right to buy the financial instrument, it is termed as call option.

An option that would be profitable to exercise at the current exchange rate is termed as **in-the-money.** An option that would not be profitable to exercise at the current exchange rate is termed as **out-of-the-money**. The price . which the option is exercised is called the **strike price or exercise price**. An option whose exercise price is the same as the spot exchange rate is known as **at-the-money.**

10.5.3 Cancellation and Extension of Forward Contracts

If the exporter is not able to deliver even within the option period, he may approach to the bank either for cancellation or for extension of forward contracts. Let us discuss them in detail.

1) **Cancellation:** The customer who has booked a forward contract may not be able to execute it and therefore, request the bank for cancellation. The bank would generally agree for the cancellation provided the customer is willing to bear the loss incurred by the bank by such cancellation.

   When a forward purchase contract is cancelled on the due date, it is taken that the bank purchases at the rate originally agreed upon and sells back to the customer at the spot TT rate. The difference between these two rates is the loss on the transaction and is recovered from the customer. Of course, the amounts involved in purchasing and sale of foreign currency are not passed through the customer's account. Only the difference, being the loss on the transaction, is recovered by way of debit to the customer's account.

   In the same way when a forward sale contract is cancelled it is treated as if the bank sells at the rate originally agreed and buys back at the spot buying rate. The difference between these two rates represents the loss to the bank and is recovered from the customer.

   It is possible that the exchange difference is in favour of the customer. That is, the difference may result in a profit instead of loss. Such profit is passed on to the customer provided the contract is cancelled at the request of the customer.

2) **Extension:** An exporter may find that he is not able to export on the due date but expects to do so in about two months. So also, an importer may be unable to pay on the due date but is confident of making payment a month later. In both these cases they may approach their bank with whom they have entered into forward contracts to postpone the due date of the contract. Such postponement of the date of delivery under a forward contract is known as the extension of forward contract.

   For extension of sale contracts the exchange control regulations provide that the contract may be extended if the relative letter of credit or firm contract is extended for shipment and the import licence is valid for the extended period.

   When the bank enters into a forward purchase contract with a customer it covers its own position by selling in the inter-bank market the same amount for the same delivery period. On the due date when the contract is extended, irrespective of the fact that the customer has not delivered foreign exchange, the bank has to meet its commitment. For this purpose the bank buys spot from the market and delivers under the original contract. Supposing the customer requires extension of two months, after two months the bank would be in receipt of foreign exchange under the extended contract. To cover its position the bank enters into a forward contract for two months.

The operations involved may be tabulated as under:

On the date of the contract:

a) Purchase forward from customer

b) Sell forward to the market at market buying rate.

On due date when contract is extended:

c) Purchase spot from market at market to selling rate to fulfil (b).

d) Sell forward to market at market buying rate to cover extended delivery of (a).

The bank will charge from the customer the loss suffered by it as also interest on the outlay of funds for the extended period. It will also make a flat charge.

10.6 ECGC SCHEMES FOR COVERING EXCHANGE RISKS

The ECGC has evolved two schemes to provide greater protection to exporters of capital goods and turnkey project against the risk of fluctuations in foreign currencies. The first scheme is called **'the exchange fluctuation Risks (Bid) scheme'** to give protection in respect of bids tendered in approved foreign currencies between the date of bid and the date of contract. If the contract is not won, the ECGC refunds 75 percent of the premium paid under this policy.

If the contract is won, the exporter will be required to obtain the 'Exchange Fluctuation Risk (Contract) Cover' for eligible deferred receivables. In this situation, he will be allowed in terms of this scheme to have the rate of exchange prevailing as on the date of bid if it is more advantageous than the rate of exchange as on the date of the contract.

Check Your Progress B

1. What do you mean by forward Contract ?

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2. Distinguish between cancellation and extension of forward contracts.

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3. State whether the following statements are True or False.
   i) The Government of India has now directed that exporters will receive the bill from their importers in foreign currency only.
   ii) The currency may fluctuate during the time gap between the shipment of goods and the receipt of payment.
   iii) If Indian exporter bills in Indian currency he will not suffer any loss by depreciation of foreign currency or Indian rupees.
   iv) Importer can resort to forward purchase in order to deal with foreign exchange risks.
   v) According to the Reserve Bank regulation, the forward cover can exceed the net amount expected to be received in India.

4. Fill in blanks.
   i) If Indian exporter bills, the importer in a foreign currency, the currency may................
   ii) The method where the unit of foreign currency is kept constant and price variation is reflected in the units of home currency is known as ....
   iii) The rate at which the bank is willing to sell the currency is known as ....
   iv) Exporter can use .... in the contract with the customer providing for a revision of price in the event of significant change in currency rate.

10.7 LET US SUM UP

Foreign exchange transactions involve exchange of one country's currency for that of another country. The rate at which one country's currency is exchanged for another country's currency is known as exchange rate. The exchange rate may be either spot rate or forward rate. Spot rate refers to the current exchange rate at which foreign currency is bought or sold. On the other hand forward rate is quoted for the delivery of foreign exchange in future at some agreed rate. Depending upon the time of realisation of foreign exchange by the banks, two types of buying and selling rates are quoted in India. They are T.T. (Telegraphic Transfer) buying and selling rate and Bill buying and selling rate.

There is a time gap between the shipment of goods and the receipt of the price. During this time, the rate of currency may fluctuate. If the Indian exporter bills in Indian currency, they

will not suffer any loss by possible depreciation of foreign currency or Indian currency. Moreover, Government of India has now directed that exporters bill their importers in foreign currency only. In such cases, foreign currency may either appreciate or depreciate. If foreign currency gets depreciated, Indian exporter will sustain loss or vice versa. The firm can deal with foreign exchange risk by : (1) taking the risk (2) putting hedging clause and (3) entering into forward contract.

The bank provides forward exchange cover for the risks arising out of fluctuations in exchange rates to both the importer and exporter. For this purpose, the parties enter into the forward contract for selling or buying of foreign currency in future. Exporters/Importers have an option for option forward contract, known as currency options. Exporters/Importers may also avail the facilities of Cancellation and Extension of Forward Contracts. The ECGC has also evolved two schemes to provide greater protection to exporters of capital goods and turnkey projects against the risk of fluctuations in foreign currencies. They are Exchange Fluctuation Risks (Bid) Scheme and Exchange Fluctuation Risk (Contract) Cover.

10.8 KEY WORDS

Bid Rate: The rate at which bank is willing to buy the currency.
Exchange Rate: The rate at which one country's currency is exchanged for another country's currency.
Forward Rate: The rate quoted for delivery of foreign exchange in future at some agreed date.
Offer Rate: The rate at which bank is willing to sell the currency.
Spot Rate: The currency exchange at which foreign currency is bought or sold.

10.9 ANSWERS TO CHECK YOUR PROGRESS

A) 3) (i) False (ii) False (iii) True (iv) False (v) True
B) 3) (i) True (ii) True (iii) True (iv) True (v) False
 4) (i) Appreciate or depreciate ii) direct rate iii) offer rate iv) hedging clause

10.10 TERMINAL QUESTIONS

1) What do you mean by exchange risk ? Distinguish between spot rate and forward rate.
2) What do you mean by Telegraphic Transfer Rate and Bill Rate ? Explain their types with suitable examples.
3) Explain various methods to deal with the foreign exchange risks.
4) How the exporters and importers are exposed to exchange risks. Explain how forward contracts help them to deal with the risks.
5) What do you mean by cancellation and extension of forward Contracts? What is the impact of cancellation and extension on the customer ?
6) Write notes on
   a) Spot Rate
   b) T.T. Rate
   c) Forward Rate
   d) Bill Rate

SOME USEFUL BOOKS

Exchange Control Manual, Reserve Bank of India, New Delhi
Nabhi's Foreign Exchange Manual, 1997, A Nabhi Publication, New Delhi.
Nabhi's Exporters Manual and Documentation (New Edition), A Nabhi Publication, New Delhi.
Ram Paras: Export, What where How (New Edition) Anupam Publishers, Delhi.

Note: These questions and exercises will help you to understand the unit better. Try to write answers for them. But do not send your answers to the University. These are for practice only.