# CURRENCY HEDGING

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**There is a village known as Champak. The village is well known for the intelligence of its people. Chameli is one smart girl of the village and Chatur a smart young man, is keen to marry Chameli.**

**However, Chameli is unwilling to commit. She sets her condition that she might consider marrying him but would confirm only after one year.**

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**She comes up with an idea and makes an offer to Chatur.**

**She suggests that they draw up a contract which states that at the end of the year she might consider marrying Chatur but there would be no obligation to do so. For signing up the contract, she would pay Chatur a sum of money. As part of the contract, Chatur has to stay within bounds and not persuade her during this period.**

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**If one sees this situation from Chameli's perspective, it appears that she is "Hedging" herself or we may say she is "covering her risks" for a sum of money.**

**Chatur ,on the other hand, stands a chance of marrying Chameli after a year and the sum of money that he gets for the contract becomes the icing on the cake.**

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However, let us examine the scenario in the event of Chameli not marrying Chatur.

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Chameli would use her option of not marrying Chatur if she happens to find a groom more eligible than Chatur. The only price that she would have to bear for this decision is the sum of money that Chatur would get on account of the contract.

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So by offering this money, she covers her risks by ensuring that she enjoys the option of marrying either Chatur or somebody better. Chatur has a reasonable chance of marrying Chameli at the end of the year, but if that does not occur he at least gets to pocket the money.

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**Hedging of currency risk is similar to this story.**

**Let's say Chameli places an order to buy foreign machinery at a million dollars at the end the year. As per the contract, she will need to make the payment at the end of the year. Now let's say the value of a million dollar is 5 cr. rupees at the time of signing the contract.**

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**At the end of the year the value of the dollar rises by 10%.**

**Now she would have to cough up additional Rs. 50 lacs for the machinery (Rs 5.5 cr for a million dollars due to price appreciation).**

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**This increase in cost is not good for her business. And she looks for ways of covering such currency risk. Instead of risking what could be Rs 50 lacs, she buys a call option (you always buy a "call" option but sell a "put" option).**

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This option in essence gives her the option of either purchasing a million dollars for Rs 5 cr. or else allowing the option to expire. Logically, if the value of the million dollars falls below Rs 5 cr, she would allow the option to expire. But if the value of the million dollars goes up beyond Rs 5 cr, she would execute the option.

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**For getting the benefit of this protection, which is popularly expressed as hedging in the financial terms, she would naturally have to pay a fee or price.**

**Let's say this is Rs 5 lacs (This is just for the sake of illustration. The exact price of the option etc. is beyond the scope of this lesson).**

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So by risking Rs 5 lacs, she gets the option of purchasing a million dollars either for Rs 5 cr. or less but certainly not more. And for this she would have to pay Rs 5 lacs. agreed price fixed a year ago.)

If the price of a million dollars were to drop to Rs 4.95 cr. then she would also recover her fee, (Rs 5 lacs) and if the price were to drop to Rs 4.9 cr., she would end up making a profit of Rs 5 lacs.

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**Her total cost would then be Rs 4.9 cr for a million dollar + Rs 5 lacs as the fee = Rs 4.95 cr. which is Rs 5 lacs less than the agreed price fixed a year ago.**

**Otherwise she would risk only Rs 5 lacs in the deal for which she would get a peace of mind by ensuring that the exchange rate for her does not change over the year. This is popularly known as covering the currency risk by way of hedging through the purchase of call options.**

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**Hope this lesson has helped you in understanding the term Currency Hedging**

**Thinking of Investment**

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