Chapter 1

Introduction

Since the beginning of nineteen seventies there has been extreme volatility and instability in international currency market. This situation was aggravated due to differences in the economic performances of countries, political situation, monetary and fiscal policies. Attempts to impose a fixed exchange rate regime, first in relation to gold and then in terms of the USD (after Second World War), were dropped in favour of a market determined exchange rate regime by the major currencies in the early seventies. Since then, volatility in foreign exchange market has been the rule rather than the exception.

Due to growing tendency towards globalisation and liberalisation adopted by economies across the globe, business enterprises of present day have ready access to foreign markets for procurement and distribution of products and services. Cross-border financing and investing are taking place on an ever-increasing scale. While the uncertainty associated with these phenomena cause volatility in the parity value of currencies, it is also a matter of serious concern for individual firms as it affects and often weakens their financial and profitability status.

One basic problem that business enterprises which are into international business face is currency exposure. This problem can affect the cash flows of the enterprise, its profitability and even its existence. In the words of Apte (2006), “Foreign exchange / Currency exposure is the sensitivity of changes in the real domestic currency value of assets, liabilities or operating income to unanticipated changes in exchange rates”. Currency risk is the likely or probable loss from such currency exposure due to adverse exchange rate fluctuations. It is the risk from adverse movements in exchange rates. When a business enterprise has assets
or liabilities denominated in a foreign currency or contracts to receive or pay in a foreign currency, it has an exposure to that currency.

What could otherwise be a profitable business transaction or investment may be rendered unprofitable on realization because of exchange rate fluctuations. Conversely, favourable currency movements may turn potentially unprofitable transactions into profitable. The more currencies involved and the longer the time period before settlement of business transaction, the more complex is the management of the currency exposure and the greater the implications of its mismanagement.

Generally business enterprises face three types of currency exposure: transaction (commitment) exposure, economic (operational, competitive or cash flow) exposure and translation (accounting) exposure. These exposures are categorised depending upon which aspect of the operations of an enterprise the said exposure affects. Transaction exposure is a measure of the sensitivity of the domestic currency value of assets and liabilities, which are denominated in a foreign currency to unanticipated changes in exchange rates, when the said assets or liabilities are liquidated. The foreign currency values of these items are contractually fixed, i.e., they do not vary with the exchange rate. It is also known as contractual exposure. On the other hand, operating exposure deals with the impact of changing exchange rates on the enterprise’s own operations over the coming months and years and on its competitive position vis-à-vis other firms. Whereas, translation exposure is the potential for an increase or decrease in the parent’s net worth and reported net income caused by a change in exchange rates since the last translation. Here no cash movement is involved, since the subsidiary is not to be liquidated.

Currency exposure management is the appropriate management of foreign currency assets, liabilities, income and expenditure with a view to maximising earnings and minimizing costs. It involves using both internal and external techniques like selection of the right currency for invoicing, leading or lagging,
judicious matching of imports and exports and finally, proper usage of derivative instruments and facilities available for the purpose.

India started facing balance of payments problems since 1985 and by the end of 1990, it was in a serious economic crisis. The government was close to default, RBI had refused new credit and foreign exchange reserves had reduced to the point that India could barely finance three weeks’ worth of imports. The Balance of Payments crisis in 1991 pushed the country to near bankruptcy. In return for an IMF bailout, Gold was transferred to London as collateral, the rupee was devalued and economic reforms were forced upon India. At that time there was a need to transform the economy through badly-needed reforms to unshackle the economy. Controls started to be dismantled, tariffs, duties and taxes progressively lowered, state monopolies broken, the economy was opened to trade and investment; private sector enterprise and competition were encouraged and globalization was slowly embraced. Similarly, the establishment of a new unified market-determined exchange rate and a phased introduction of current account convertibility opened up the Indian economy to a great extent. Further trade liberalization, greater access to foreign capital and finally full capital account convertibility has been certainly on the agenda of the Indian government.

Under Indian context, originally, currency exposure was not a problem at all because, parity value of Indian rupee was determined and held constant for a long period of time by the Government of India. It remained fixed for very long period of time. Even when parity value underwent a fluctuation, there used to be continuous depreciation. This trend of continuous depreciation was favorable to Indian exporters. After the declaration of policy of liberalization in early nineties, India resorted to Market determined Exchange rate system. Even after this, initially, for quite some time (almost a decade) there was continuous depreciation in the parity value of Indian rupee. However, since 2003, there started a trend wherein the inflow of Foreign exchange to India continuously increased and hence resulted in a trend of appreciation. It is this trend of appreciation which caused serious stress on finances of the exporting business houses. Exchange rate of Indian rupee against major currencies, especially USD underwent a
drastic appreciation in the year 2007 and the trend was reversed in 2008 when there was a drastic depreciation. Since middle of 2009, there has been a short-run continuous volatility of exchange rate. Appreciation and also volatility of exchange rate are matters of deep concern for Indian business enterprises involved in overseas activities, especially exporters.

1.1 Need for the Study

The need for the study arises because of the following:

1) The Indian economy is going through a period of transition in the light of liberalization adopted by the government of India. This is observed in terms of the continuous inflow of funds for investment in India from abroad and its deep impact on the exchange rate of Indian currency in international market.

2) There has been a significant increase in the number of Indian business enterprises exporting their products and services. This increase is observed not only in terms of the variety of products and services but also volume, value and increased inflow of earnings in foreign exchange.

3) Unlike in the past, Indian enterprises are now directly entering the foreign capital markets to raise their investment requirements.

4) The generally observed continuous and uncertain downward slide of the parity value of Indian rupee is now being replaced by a gradual, uncertain upward swing of the Indian rupee in relation to currencies of developed economies.

5) The excessive usage of USD (which by itself is faced with high degree of volatility in the international currency market) for overseas operations by Indian enterprises and the excessive volatility of Indian rupee against USD has been resulting in a high degree of currency exposure for Indian business enterprises.
1.2 Objectives of the Study

The basic objective of the study is to understand and evaluate the management of currency exposure as practiced by Indian business enterprises of different categories engaged in multinational business. The above primary objective can be subdivided into the following specific objectives:

1. To ascertain the degree of currency exposure faced by the Indian business enterprises and study the seriousness with which they view the problem of currency exposure.

2. To study the techniques used by different categories of business enterprises to address the problem of currency exposure.

3. To evaluate the role of the government in application of regulatory and supportive measures with reference to currency exposure management by Indian business enterprises.

4. To offer suggestions that may help the business enterprises in managing their currency exposure.
1.3 Hypotheses

The following hypotheses were tested towards the realization of the objectives:

**Hypothesis 1**: The degree of currency exposure faced by Indian business enterprises is high.

**Hypothesis 2**: Currently Indian business enterprises have not taken the problem of currency exposure with the seriousness which it deserves.

In realization of the above hypothesis, the following sub hypotheses were tested:

2(1) In the process of assessment of currency exposure business enterprises give little importance to various factors that need to be considered.

2(2) Indian business enterprises are asymmetrical in reckoning their currency exposure position.

2(3) Computation of impact of currency fluctuation on profitability is overlooked by Indian business enterprises.

2(4) Forecasting of currency movement is ignored by Indian Business enterprises.

2(5) Practice of maintaining a separate department / team for accurate assessment and management of currency exposure is rare among Indian business enterprises.

2(6) Exposure management policy is nonexistent among Indian business enterprises.
Hypothesis 3: Management of currency exposure is not taken up by Indian business enterprises with the seriousness which it deserves.

In realization of the above hypothesis, the following sub hypotheses were tested:

3(1) Frequent management of currency exposure is nonexistent among Indian business enterprises.

3(2) Enterprises who manage their currency exposure, while taking such decision are inconsiderate about various internal and external factors.

3(3) Minimizing foreign exchange losses is the most important objective of Indian business enterprises while managing the currency exposure.

3(4) Indian firms lay greater emphasis on tackling transaction exposure than operating and translation exposure.

3(5) There is deficiency on the part of Indian business enterprises in using internal techniques to manage currency exposure.

3(6) There is deficiency on the part of Indian business enterprises in using external techniques to manage currency exposure.

3(7) Proportion of currency exposure managed with derivative instruments by Indian business enterprises is less.

3(8) There is deficiency on the part of Indian business enterprises in using EEFC / Other foreign currency account.

Hypothesis 4: Indian business enterprises feel that regulations are stringent in India as far as currency exposure management is concerned.

Hypothesis 5: Indian Business enterprises are dissatisfied with the support of the government / RBI in tackling the problem of currency exposure.
Hypothesis 6: There is a significant difference among different categories of business enterprises as far as the seriousness with which they approach and manage the problem of currency exposure is concerned.

1.4 Methodology of the Study

The present empirical study is undertaken with an objective of understanding and evaluating the management of currency exposure as practiced by Indian enterprises of different categories engaged in multinational business. The various facets of research methodology are given below.

Data:

The present study deals with the currency exposure management of Indian business enterprises. The study is mainly based on primary data. The required primary data was collected using well-structured and pre-tested questionnaire administered to business enterprises situated in different parts of India. The questionnaire was administered through several channels, which included surface mail, e-mail and personal participation. Secondary data was collected through the extensive review of books, articles, reports, newspapers, portals etc.

Sample:

The survey was conducted with the pre-tested questionnaire administered on 90 business enterprises in India having foreign currency exposure. Stratified random sampling method was used for selecting the business enterprises for the study. Stratification was done based on the Industry sector the respondent enterprise belongs to. The respondent enterprises were thus classified as IT (information technology) sector respondents, Pharmaceutical sector respondents and rest of the respondents were categorised as ‘Other sector’. Business enterprises were selected from the database of business enterprises found in latest ET 500, FIEO (Federation of Indian Exporters Organisation),
FKCCI (Federation of Karnataka Chamber of Commerce and Industry), etc. The respondents to the questionnaire are finance managers with responsibility of managing currency exposure in their respective organizations. Out of 145 questionnaires sent to the selected enterprises, 96 responses were received, of this, 6 responses had to be eliminated, as they were incomplete in many respects. Thus **sample size of the present study is 90 business enterprises having currency exposure**. Out of 90 respondents taken part in the survey, 38 are IT companies, 17 are pharmaceutical companies and the remaining 35 are into various Other business activities.

**Analytical tools:**

Apart from conducting pilot test, reliability analysis recommended by Cronbach (1951) was also applied to test the internal consistency of the instrument. The analysis showed that the Alpha-Cronbach coefficients were in the range of 0.73 to 0.85. According to Nunnally (1978), reliability co-efficient of 0.7 and above is considered adequate. Accordingly, the research instrument used in the study was internally consistent and reliable.

In analysing the responses of the respondent enterprises, the Microsoft Excel Spreadsheet and SPSS software have been used. Certain tested and tried Statistical tools such as percentages, averages, frequencies have been used. Apart from these basic tools, **T test** and **F test (ANOVA)** were applied to test the hypothesis. The following paragraphs give the brief description and empirical support for T test and F test.

**One sample t-test:** One sample t-test allows testing whether a sample mean (of a normally distributed interval variable) significantly differs from a hypothesized value. It is a statistical procedure that is used to know the mean difference between the sample and the known value of the population mean (test value) and thereby test the hypothesis. The theory of statistics on sampling suggests that any sample below 30 numbers or observations form a small sample. Any observations above 30 form a large sample. This broad classification into small and big does not justify the nature of sampling distribution (Alan and Keith...
(1994). Similarly authors such as Bartlett (1935), Bradley (1980), Pearson and Please (1975), Pocock (1982) and Subramanian, and Messeri (1975) recommend to disregard the large-sample/small-sample distinction and use the T-test regardless of sample size. They rely on studies showing that the t-test is reasonably robust against the violation of the normality assumption for large sample sizes, except for extremely skewed populations. The t’ statistics used in this study is hence, justified in the context of the results of statistical inference. .Krishna Swamy and Sesaiah (1985) used t-test to examine the significance of linear and compound growth rate of branch expansion of banks in India in the post nationalization period.

ANOVA (F test) is a statistical method that stands for analysis of variance. This test is also called the Fisher analysis of variance. The ANOVA is designed to test whether a significant difference exists among the three or more sample means. In this analysis, the total variance in a set of data is divided into variance between and variance within the groups. The ANOVA used for studying the differences among the influence of various categories of one independent variable on a dependent variable is called one way ANOVA. Conducting ANOVA has been strongly suggested by Gautam and Narayan (1985) in their case study on organizational effectiveness and Howell and Frost (1989) in their study on charismatic leadership used one-way ANOVA to test the hypothesis.

1.5 Limitations of the Study

The research is subject to the following limitations:

- Currency exposure management followed by the respondent enterprises was studied at a certain point in time but not over a period of time.

- Results derived are based on the perceptions of the respondents. Perception of respondents may vary from time to time depending on the fluctuations in the exchange rate and other relevant factors.
• The present study is based mainly on primary source of data. The currency exposure faced by the respondent enterprises could not be measured by analysing their financial statements. The key reason for this is that listed companies in India are not disclosing all the information which is needed to measure the currency exposure. Moreover, the survey includes the unlisted companies who are not under any legal compulsion to publish their financial records.

1.6 Chapter scheme

Keeping in view the various dimensions of the research problem on hand, the present thesis is divided into six chapters. The detailed description is given below.

Chapter I: Introduction – This chapter presents the background, need and the objectives of the study. Furthermore, it covers the research methodology, hypotheses, and limitations of the study and chapterisation scheme.

Chapter II: Literature Review - In this segment, various previous studies pertaining to currency exposure management are reviewed. It comprises both International studies and Indian studies.

Chapter III: The Problem of Currency exposure and its management – The third chapter furnishes theoretical overview of currency exposure and different techniques used to manage it.

Chapter IV: The Problem of Currency exposure and its management in India - In this chapter an attempt is made to provide status of currency exposure management in India.

Chapter V: Analysis of results - This chapter deals with the analysis of primary data collected from respondent enterprises belonging to different categories.

Chapter VI: Summary of Findings, Suggestions and conclusion - In this chapter the findings are summarized and suggestions are offered to the respondents which may help them in better management of their currency exposure.