CHAPTER 13 MANAGEMENT OF TRANSACTION EXPOSURE
SUGGESTED ANSWERS AND SOLUTIONS TO END-OF-CHAPTER QUESTIONS AND PROBLEMS

QUESTIONS

1. Define transaction exposure. How is it different from economic exposure?

Answer: Transaction exposure is the sensitivity - due to unexpected changes in exchange rates - of the domestic currency value of a firm's contractual cash flows that are denominated in foreign currencies. Unlike economic exposure, transaction exposure is well-defined, transaction-specific and short-term.

2. Discuss and compare hedging transaction exposure using the forward contract versus money market instruments. When do the alternative hedging approaches produce the same result?

Answer: Hedging transaction exposure by a forward contract is achieved by selling or buying foreign currency receivables or payables forward. On the other hand, a money market hedge is achieved by borrowing or lending the present value of foreign currency receivables or payables, thereby creating offsetting foreign currency positions. If interest rate parity holds, the two hedging methods are equivalent.

3. Discuss and compare the costs of hedging by forward contracts and option contracts.

Answer: There is no up-front cost of hedging by forward contracts. Hedging with options, however, requires the hedger to pay the option-premium up-front. The cost of forward hedging, however, may be realized ex post when the hedger regrets the hedging decision since the forward hedge means that firm gives up the "up-side" (an unexpected favourable movement of the exchange rate) while protecting the firm from the "down-side" (an unexpected adverse movement of the exchange rate).

4. What are the advantages of a currency option contract as a hedging tool compared with the forward contract?

Answer: The main advantage of using options contracts for hedging is that the hedger can decide whether to exercise options in light of the realized future exchange rate. An option is a right but not an obligation