International Research Journal of Management and Commerce
ISSN: (2348-9766)
Impact Factor- 5.564, Volume 5, Issue 3, March 2018
Website- www.aarf.asia, **Email** : editor@aarf.asia , editoraarf@gmail.com

CURRENCY DERIVATIVES – AN EXPLORATIVE STUDY

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Derivatives - Prelude

In simple terms the derivative itself is a contract between two or more parties based upon the asset or assets. Its value is determined by fluctuations in the underlying asset. The most common underlying assets include stocks, bonds, commodities, currencies, interest rates and market indexes[1]. The present paper is a modest attempt to examine the status of currency derivatives trading in Indian Capital Market. The study is based on secondary data collected from National Stock Exchange of India (NSE).

A currency future, also known as FX future, is a futures contract to exchange one currency for another at a specified date in the future at a price (exchange rate) that is fixed on the purchase date. On NSE the price of a future contract is in terms of INR per unit of other currency e.g. US Dollars. Currency future contracts allow investors to hedge against foreign exchange risk. At present, Currency Derivatives are available on four currency pairs viz. US Dollars (USD), Euro (EUR), Great Britain Pound (GBP) and Japanese Yen (JPY). Currency options are currently available on US Dollars[2]

Advantages of Currency Derivatives

Currency Derivatives are considered as very efficient risk management instruments and the investors can derive the following benefits:

i. Hedging: investors can protect your foreign exchange exposure in business and hedge potential losses by taking appropriate positions in the same. For e.g. If you are an importer, and have US Dollars (USD), Euro (EUR), Great Britain Pound (GBP) and Japanese Yen (JPY) payments to make at a future date, you can hedge your foreign exchange exposure by buying US Dollars (USD), Euro (EUR), Great Britain Pound (GBP) and Japanese Yen (JPY) and fixing the payout rate today.

ii. Speculation: one can speculate on the short term movement of the markets by using Currency Futures. For e.g. If investors expects oil prices to rise and impact India's import bill, they would buy USDINR in expectation that the INR would depreciate. Alternatively if it is believed that strong exports from the IT sector, combined with strong FII flows will translate to INR appreciation they would sell USDINR.

iii. Arbitrage: investors can make profits by taking advantage of the exchange rates of the currency in different markets and different exchanges.

iv. Leverage: one of the attractions of the currency derivatives is that one can trade in the currency derivatives by just paying a % value called the margin amount instead of the full traded value.

Currency Futures

Table -1: Turnover in the currency futures segment

Year	No. of Contracts	Turnover in Cr. Rs
2008-09	3,26,72,768	1,62,272.43
2009-10	37,86,06,983	17,82,608.04
2010-11	71,21,81,928	32,79,002.13
2011-12	70,13,71,974	33,78,488.92
2012-13	68,41,59,263	37,65,105.33
2013-14	47,83,01,579	29,40,885.92
2014-15	35,55,88,963	22,47,992.34
2015-16	40,97,59,364	27,49,332.96
2016-17	36,26,15,931	24,89,778.94

.Source: Compiled from www.nseindia.com

From the above table (Table-1) it is evident that the journey of currency futures has been started in the year 2008-09. Within a span of three years the number of contracts have been soared to a highest (i.e. 71,21,81,928). Post 2010-11, there was a declining trend in terms of number of contracts. As far as the turnover is concerned, in the first year the turnover was reported as Rs. 1,62,272.43 crores. The turnover reached to highest of Rs. 37,65,105.33 crores in the year 2012-13. Due to various reasons such as slowdown of economy, poor performance of corporates and etc..

Currency Options

Table -2: Turnover in the currency options Segment

Year	No. of contracts	Notional Turnover Rs. in crores	Premium Turnover Rs. in crores
2010-11	3,74,20,147	1,70,785.59	946.70
2011-12	27,19,72,158	12,96,500.98	7,100.69
2012-13	27,50,84,185	15,09,359.32	10,109.99
2013-14	18,18,90,951	10,71,627.54	7,297.15
2014-15	12,50,75,731	7,75,915.32	3,164.45
2015-16	26,38,23,800	17,52,552.62	6,059.00
2016-17	34,98,35,508	23,67,296.92	7,153.09

Source: nseindia.com

The trading of currency options have begun in the year 2010 -11. The above table (Table-2) depicts trading volume, value and premium turnover details. The number of contracts were 3,74,20,147 in the year 2010-11 and the same reached to a peak of 34,98,35,508 (almost 10 times) in the year 2016-17.

Reasons for growth

The following few points are the main reasons for the growth of currency derivatives trading in India.

1. Price Fluctuations (Exchange rate volatility)

The changes in the exchange rate are the prime concern of the investors to enter into currency futures/options. The ever changing prices of foreign currencies are drawing the attention of the investors. With less risk currency derivatives are offering good returns.

2. Globalization

Till recent times, investors had to deal with domestic economic concerns; what happened in other part of the world was almost irrelevant. Now globalization has increased the size of markets and alternative avenues of investment. It has also exposed the modern business to significant risks and, in many cases, led to cut profit margins

In Indian context, South East Asian currencies crisis of 1997 had affected the competitiveness of Indian products vis-à-vis depreciated currencies. Export of certain goods from India deteriorated because of this crisis. Steel industry in 1998 suffered its worst set back due to cheap import of steel from south East Asian countries. Suddenly profitable companies had turned in to losses. In addition, the fear of china devaluing its currency created instability in India's foreign trade particularly in respect of exports. Thus, it is evident that globalization of industrial and financial activities necessitates use of currency derivatives to protect against future potential losses. This factor alone has contributed to the growth of currency derivatives to a great extent.

3. Investor awareness

Investors are looking for new and innovative instruments to deploy their savings. Currency derivatives are attracting the new investors by offering good returns.

4. Technological advancements

Online/internet trading, Direct Market Access (DMA) to institutional clients including FIIs, Co-location facility where broker can have a server located in the exchange premises, algorithmic trading, mobile trading are gaining importance day by day and volumes are getting shifted to the users of these technologies.

There is need to introduce more currency derivatives products in India and has long strides to take in terms of providing larger liquidity and depth to the bigger market players. There is also need to increase the basket of products for trading so as to provide the variety of avenues for investments and/or trading in the currency derivatives market. Particularly, there is need to introduce more derivatives instruments aimed at retail investors to increase the larger participation in the currency derivatives segment.

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