Economics of currency derivatives

The Standing Committee on Currency Derivatives constituted recently by the Securities Exchange Board of India (Sebi) and the Reserve Bank of India (RBI) has proposed to allow futures trading in currencies on already-established commodity and stock exchange platforms. This proposal is worthy of applause, since it will help in expeditious execution of the idea. After all, the established stock and commodity exchanges have the requisite mobilisation capacities, owing to their well-established and already-operating derivative trading mechanisms, suitable organisational structures, exchange risk administration resources, excellent monitoring and surveillance systems in place, etc.

Currency derivative trading owes its origin to commodity derivative trading. Yet, despite a long history of commodity futures, currency futures were introduced as late as 1972 at the Chicago Mercantile Exchange (CME), only after the international gold standard was abolished and currency values were allowed to "float". Commodity traders at the CME realised that their inaccessibility to inter-bank exchange markets would place them in tight corners, as violent fluctuations were taking place in the currency market. Realising their urgent need and appreciating the inevitable commodity-currency nexus, CME lost no time in establishing the International Monetary Market (IMM), initially as an independent exchange. Thus, emerged the first ever currency futures market in the world with exchange-traded standardised futures contracts on major world currencies as a substitute, and to an extent as an adjunct, to the enormous forward market in currencies that then existed and still exists. However, over time, the IMM was merged with the CME.

The linkage between commodity and currency futures is evident not only in the origin of the latter, but the nexus has been increasing over time. As it is, globally traded commodities, in terms of their number and volume, have increased exponentially with the accelerated movement towards globalisation year after year. The vagaries of international trade and finance are being faced by developing nations with the steady dismantling of trade and tariff barriers and reduction in protective commodity subsidies under the aegis of the World Trade Organization (WTO). This has relentlessly exposed various players in the commodity value chain (commodity traders, importers, exporters, processors, manufacturers, small and medium enterprises trading in commodities and their products, etc.) to two types of market risks: commodity price risks and currency value risks. Actually, the two risks are not quite independent of each other, but are closely inter-related. Currency fluctuations cause price movements in the international commodity markets; surges and slides in commodity prices, in turn,

upset trade balances and bring about the consequential changes in currency values.

Be that as it may, both commodity and currency price risks, irrespective of their sources of origin and causes, can pull down operating margins of commodity players of diverse hues, especially in a fiercely competitive international trade environment, and hence need to be countered not just effectively, but, even more importantly, concurrently. Empirical literature has, time and again, vividly revealed that international players in commodities can improve their competitive efficiency by hedging foreign exchange exposure, no sooner than they hedge their commodity price risks. It is therefore quite logical, as also absolutely essential, for a commodity market functionary to take appropriate positions in both commodity and currency derivative contracts to hedge both the risks together. It is but natural that a commodity hedger taking a position in a commodity exchange would prefer to look out for another instrument on the same exchange platform, with the operations and regulations of which he is very familiar.

Besides agro-commodities, the major commodities traded on the national commodity exchanges in India are mostly either imported or exported. These include crude oil, precious and non-ferrous metals, natural gas, steel and carbon credits. While importers of these commodities need to hedge their import commitments against the possible risk of a change in the prices of the commodities concerned, they must also safeguard themselves from paying a higher price for imports on receiving shipments, if the Rupee were to depreciate during the intervening period. On the other hand, not only do commodity export commitments call for long hedges in commodity futures to avoid the risks of price rises to ensure procurement or production of supplies for shipments on due dates at costs not higher than those envisaged at the time of entering into export orders, but also must hedge in currency futures against the appreciation of the Rupee, lest export earnings unexpectedly drop.

Commodity traders are also exposed to vagaries of freight costs on their shipments, especially when export-import commitments are based on CIF or C&F prices that are quoted in foreign currencies. With the uncertainty in oil prices and the unusual firmness witnessed in them, risks on freight costs have taken new dimensions, of late. The currency derivative mechanism will, definitely, be an instrument to combat the freight cost volatility caused due to exchange rate fluctuations.

The benefits of currency derivatives are not confined to commodity markets (despite the inseparable linkage between the two), but also extends to the financial institutions like banks, which lend against commodities. Although bank advances are covered to some extent by appropriate margins, commodity and currency price volatility more often than not expose banks to unforeseen risks on

the stocks pledged/hypothecated with them. Banks may therefore find it more beneficial to hedge their commodity and currency risks on such stocks on exchanges that offer facilities to cover both the uncertainties.

As the development of currency futures in stock exchanges will augment the participation of foreign investors, who can hedge against currency risks, investors in commodity exchanges will benefit from trading in currency futures to ensure their return on commodity investments, since commodity prices are closely related to exchange rate movements. That will improve liquidity in both the markets and help in real time price discovery for commodities as well as currencies.

Incidentally, the competition amongst several stock and commodity exchanges trading in currency derivatives simultaneously will not only help improve their operating efficiency, but also facilitate arbitrage, usher in liquidity, reduce exchange rate volatility, and reduce, as a consequence, the total transaction costs, benefiting in the process the market players, while servicing their varied needs, including those of price discovery, risk management, market intelligence and information dissemination fairly proficiently.

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I. Currency Derivatives - How and What

II. Very Important Reports and Circulars about Currency Derivatives newly introduced in Indian Market :-

1. Report of the RBI-SEBI Standing Technical Committee on Exchange Traded Currency Futures

2. RBI Guidelines on Trading of Currency Futures

3. SEBI Circular on Exchange Traded Currency Derivatives

III. Product Descriptions and Frequently asked Questions