A right beginning to a bright future





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Though exchange-operated currency futures are still at a nascent stage in India, it can go a long way in helping us duel with global risks and uncertainties

Although a risk management system to hedge the currency risk has long existed in India in form of over-the-counter (*OTC*) market, the ever-increasing frequency and scale of risk exposure has necessitated a more transparent and efficient mechanism in the country. To overcome this problem government decided to allow futures trading in currency beginning August 2008. Currency derivatives trading picked up since then beating the expectations of many.

The country's derivatives turnover for 2007 was about 29 times its national commerce estimated at $440 billion. Though this is a significantly large figure, it falls fairly short of the size of the global derivatives market that was 40 times the international commerce of over $63 trillion in the same year.

The large size of the Indian derivatives market is very much commensurate with the country's ever-growing exposure to various global risks, high price volatility, and an increased number of asset classes such as equities, commodities, and currencies. In this context, it is pertinent to look at the scale of risk only the traders are exposed to in terms of the price and exchange rate volatility. India's international commodity trade for 2007-08 stood at more than $272 billion. With an annualised volatility at 14% as found in the composite index of prices (*COMDEX*) and 6% volatility in Indian rupee during the same period, Indian traders were exposed to a massive risk of $55 billion/annum due to commodity price and exchange rate fluctuations. It is quite evident that the unhedged positions with regard to either type of risk would mean a big blow to the competitiveness of traders. The recent development involving the palm oil importers amply illustrates this. The importers were caught on the wrong side of the fence by a sudden crash in the international benchmark prices by the time the forward contracts they had entered into matured for delivery. No wonder, they ended up defaulting on their import obligations, thus hurting their credibility in the global market.

The incident emphasises the need for hedging both price and exchange rate risks efficiently in order to stay competitive. As for hedging against the price risk, an efficient risk management instrument in the form of commodity futures has been available since 2003, thanks to the burgeoning growth and spread of the country's online national commodity exchanges. However, despite a huge daily turnover of $34 billion in the OTC market, until August 2008 when the futures trading in currency was started, there had not been a transparent and efficient hedging avenue for entities facing the risk of exchange rate fluctuations.

The exchange-traded currency futures overcome many of the flaws that plague the OTC market. First, the exchange-traded currency futures offer a single quote for a specific contract to all the participants at any given point of time, while in the OTC market contract prices vary depending on the relationship between the issuer and the client. Second, the cost of trading at these fully transparent exchanges is relatively low. The high liquidity build-up on these state-of-the-art electronic exchanges, through the leveraging of their robust technology and best risk management practices, results in lower cost of participation and more efficient price discovery. Additionally, the counter-party-risk, which is a major limitation of the OTC market, is fully taken care of by the exchange operated derivatives.

These are, however, still very early days for the exchange-operated currency futures in India and the market has a long way to go. As they evolve along the way at par with other derivative markets, and as participation and product portfolio grows with the likely permission for the participation of increased number of heterogeneous stakeholders to come on board on the exchange platform attracted by relevant products, the benefits to businesses and the economy would multiply. No doubt, strengthening derivative markets would also make us more confident in taking on one of the major challenges of an open economy *i.e.* spreading global risks, in a seamless manner.