DEPARTMENT OF COMMERCE AND FINANCIAL STUDIES
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MBA (Financial Management)

Course Code: FMCC8/24

Course Name :FOREIGN EXCHANGE MANAGEMENT

Unit – III / Topic : Strategies Using Currency Futures

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SCHEME OF THE PRESENTATION

- Role of Speculation in Futures Markets
- Hedging using Currency Futures
- Concept of Arbitrage
- Use of Arbitrage in Currency Futures Markets
- Surveillance System and Procedures of Exchanges.

Market Participants

- Hedgers
- Speculators
- Arbitrageurs

Hedgers

- These types of participants have a real exposure to foreign currency risk on account of their underlying business and their objective is to remove the FX risk using currency futures.
- The exposure could be because of imports/ exports of goods/services, foreign investments or foreign expenditure on account of travel, studies or any other type of need resulting in FX exposure.
- In other words, anyone having a mismatch in foreign exchange earnings and expenses would have an actual exposure to foreign exchange.

Speculators

•Speculation plays a crucial role in futures markets by contributing to liquidity, price discovery, and overall market efficiency.

•Speculators, unlike hedgers, enter the market with the primary goal of profiting from price fluctuations rather than reducing risk.

•Their active participation increases the volume of trading, making it easier for other participants, such as hedgers, to buy or sell contracts without significantly affecting prices.

Arbitrageurs

- This set of market participants identify mispricing in the market and use it for making profit.
- They have neither exposure to risk and nor do they take the risk.
- Arbitrageurs lock in a profit by simultaneously entering opposite side transactions in two or more markets.
- For example, if the relation between forward prices and futures prices differs, it gives rise to arbitrage opportunities.
- Difference in the equilibrium prices determined by the demand and supply at two different markets also gives opportunities to arbitrage.

Computing payoffs from a portfolio of futures and trade remittances

- The market participants may undertake various kinds of currency positions and it is important to understand the payoff from these positions.
- A market participant may buy or sell in the futures market and this transaction may be linked to an underlying trade transaction (export, import or any kind of actual FX exposure) or it may not be linked to any trade transaction.
- When it is linked, the computation of payoff of the combined transaction (futures + underlying trade transaction) will be a summation of payoff of futures contract and the payoff from the trade transaction.

Combined position of futures and underlying export trade remittance

- The effective price would be summation of effect of change in USDINR price on the underlying trade transaction and the effect of change in future price on the currency futures contract.
- Using currency futures, exporter is able to mitigate the risk of currency movement.

Combined position of futures and underlying import trade remittance

- The effective price would be summation of final price at which import remittance was made and payoff from the futures contract.
- In case of full hedging, the effective price is different from the contracted price of futures
- The difference is due to the difference in the final settlement price of futures contract and the price at which remittance was done.

Using currency futures for hedging various kinds of FX exposures

Some of the common purposes/ transactions, in addition to import/export, which could use currency futures for the purpose of hedging, are as follows:

- Payment in foreign currency for travel abroad, for education, for medical treatment, payment for employees based abroad, etc.
- Payment of loan availed in foreign currency
- Investment in assets outside India or repatriation of capital invested outside India
- Payment of loan installments in INR by a person earning in foreign currency

Trading spreads using currency futures

- Spread refers to difference in prices of two futures contracts.
- A good understanding of spread relation in terms of pair spread is essential to earn profit.
- Considerable knowledge of a particular currency pair is also necessary to enable the trader to use spread trading strategy.
- Spread movement is based on following factors:
  - Interest Rate Differentials
  - Liquidity in Banking System
  - Monetary Policy Decisions (Repo, Reverse Repo and CRR)

Limitations of currency futures for hedgers

- Exchange traded currency futures contracts are standard contracts which are settled in cash i.e. without delivery of currencies.
- For hedgers, there might be a mismatch in the timing of settlement or cancellation of futures contract and the timing of actual trade remittance.
- This timing mismatch may result in small loss of value as compared to OTC forward contract.
- However, the transparency, small lot size and ease of trade execution may offset it.

References

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