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Why RBI's intervention in rupee futures market is prudent

Given the event risk behind a US rate hike, the RBI likely fears speculators will use it to short the rupee if the hike is more than expected

Shishir Asthana | Mumbai
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Reserve Bank of India (RBI) added to nervousness in the markets by [announcing that they would intervene](#) in the Exchange Traded [Currency Derivatives \(ETCD\)](#) market, if required. Ironically, the reasoning behind such a move by the central bank is to curb nervousness and volatility.

The markets have been surprised by the development and believe that the [RBI](#) feels that the 'perfect storm' –

RBI intervention triggers stop-losses in the rupee

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which the World Bank has warned of if the US raises interest rates – is a reality. The US Federal Reserve is expected to meet in a week's time to consider a rate hike for the first time since the financial meltdown of 2008.

So what does the RBI's intervention in [ETCD](#) mean and why is the market jittery?

[ETCD](#) is the [currency](#) equivalent of [futures](#) market in equities. Currencies can be traded on the [ETCD](#) through a leverage position, which in that market is very low. As per the current norms, for a lot of \$1,000 (equivalent to around Rs 67,000) the margin required is only Rs 1,800, or only 2.7%. As compared to these margins in the [currency](#) market, stocks attract a margin of around 40%, while equity indices need 20%.

But unlike the [futures](#) market, in [equities](#) where a large number of shares are traded, [ETCD](#) currently has only four [currency](#) pairs; rupee-dollar, rupee-yen, rupee-euro and rupee-pound. The general practice that is followed by exchanges is that if they are expecting high volatility based on some event risk, they increase margins. This makes it costlier to disturb the market and protects brokers and exchanges from any surprise moves.

As in equities, the [currency](#) market also has a spot market. Rates between the two markets are aligned by arbitragers who take advantage of mispricing in balancing the rates. Speculators and hedgers prefer the [futures](#) market over the spot market as the leverage position makes their cost lower.

The [RBI](#) occasionally intervenes in the spot and forward markets to maintain [currency](#) rates. It has rarely ventured into the [ETCD](#) market. But given the event risk behind the rate hike, [RBI](#) perhaps feels that speculators would like to use the opportunity to short the Indian rupee, if the hike is more than expected. Since it is cheaper to trade in the [ETCD](#) market, volatility in the [futures](#) market can spread in the spot and forward markets too, especially since it has happened in the past.

In May 2013, when the Fed had announced tapering of its quantitative easing process, [rupee](#) touched a new low of 68.85 against the [dollar](#) triggering a flight of capital from India as well as all emerging markets. During this time it was observed that volumes in the [ETCD](#) market had shot up. [RBI](#) deputy governor H.R.Khan felt that [speculative activity in ETCD](#) influenced the rupee's fall.

In order to allow a smoother transition, [RBI](#) has decided to keep the option open of interfering in the [futures](#) market.

Though the central bank's move is prudent, market participants cannot be blamed for feeling that perhaps the central bank is anticipating a flight of capital, especially since foreign holdings in Indian sovereign and corporate notes have fallen by \$204 million in December after declining by over \$700 million since May 2015. Withdrawals from [equities](#) have been more frantic with \$1.6 billion leaving Indian shores since October 2015. [RBI](#)'s steps are measures to allow an orderly exit.

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