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RBI ushers in trading in inter-bank currency market

Lokeshwarri SK

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Aimed at boosting liquidity and reducing volatilityin the market

BL Research Bureau:

Most discussions on the steps initiated by the RBI to deepen the financial markets last week revolved around bond market reforms.

But significant changes have been brought about in currency trading as well. In a bid to improve liquidity, the central bank has provided a small window through which trading can be done in the inter-bank OTC (over-the-counter) market.

The RBI, under Governor Raghuram Rajan, had been quite concerned about the subdued volumes and low participation in currency markets. The rupee is traded in the inter-bank OTC market and on the stock exchanges as exchange traded futures and options. But many foreign investors prefer to trade the rupee in offshore financial centres such as Singapore or Luxembourg.

Since the RBI does not have any control on the movement of the currency in these offshore markets, it was feared that the currency would be exposed to volatility if offshore rupee trading increases. Strong linkage between offshore and onshore price of the rupee is another reason why the central bank wants the currency trading to shift onshore.

One reason why foreign investors shift to overseas markets is the low volumes transacted in the Indian currency market. For instance, the average daily turnover in the OTC market was $58 billion in the last week of June 2012; this came down to $54 billion in June 2015.

In June 2016, the volume continued to stay flat at around $58 billion. Daily turnover in currency futures and options traded on the NSE has hovered between Rs. 18,000 crore and Rs. 20,000 crore over the last two years.

There are two ways in which liquidity can be enhanced. One, by increasing the volume traded by existing participants, and two, by allowing new participants to trade in the market. The RBI has adopted the first method.

The central bank proposes to allow entities exposed to exchange rate risk — both resident as well as non-resident — to take hedging positions up to a limit of $30 million.

The process for taking these hedges is to be significantly simplified. These positions can be taken in either the OTC market or in the exchange traded derivatives market.

Currently, there is an exposure limit of $15 million in each exchange for foreign portfolio investors. This move is in sync with the current limitations as only two exchanges — the BSE and the NSE — have enough volumes to enable FPIs to transact.

Yes to speculation

But the interesting fact is that investors can now have additional $5 million of currency position outstanding, in addition to the $30 million. This extra limit is however, available only to those already having outstanding positions of $30 million.

Since the extra $5 million is not tied to any underlying exposure, this can be used for taking directional call on currency. In other words, the RBI is partially allowing speculative transactions in the foreign currency market.

Different strokes

Over the last couple of years, the RBI has initiated many measures to improve liquidity in the currency markets. The exposure limit of foreign investors in exchange traded currency derivatives was increased to $15 million in 2015.

Three new cross-currency pairs — euro-dollar, pound-dollar and dollar-yen — were also introduced last year. The regulators are now seriously considering increasing the trading time on Indian exchanges to enable traders to make the most of the developments that take place between 5 pm and 11 pm.

Extending the trading time will be another booster for liquidity in currency markets.

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