Currency Trading

– The Biggest Market in the World

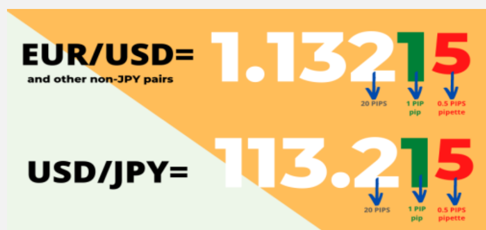
By Currency and Commodity Team

Currency trading, also known as Forex Trading, is denoted by the symbol Fx. It is one of the biggest markets in the world and is almost a USD 7 trillion market. Everyday different currencies like USD, GBP, EUR, etc. are traded in both spot and derivatives markets.

In a spot market, currency is exchanged for another at an agreed exchange rate on an immediate basis. Along with the spot market, a robust derivatives market in currency trading has been developed over the years across the world. In India, trading in currency derivatives is offered by three major exchanges, viz; National Stock Exchange, Bombay Stock Exchange and Metropolitan Stock Exchange.

Currency Quotation

Currency trading at an exchange is always done in pairs. In a currency pair, the first (left side) currency is termed as base currency and second (right side) currency is termed as quote currency. In trading, a base currency is traded or exchanged for the quote currency. Hence, in a USDINR pair, USD would be traded and exchanged for INR and termed as base currency whereas INR as quote currency.



Exchange Traded Currency Derivatives

Currency derivatives traded at an exchange are in the form of Futures and Options. Futures is a contractual trade where both buyers and sellers have an obligation to fulfill the terms, i.e. buy or sell the underlying currency even if the market has moved opposite to their position. Options provide a right to the buyer but no obligation to buy or sell the currency if the market moves adversely.

What is a Currency Futures?

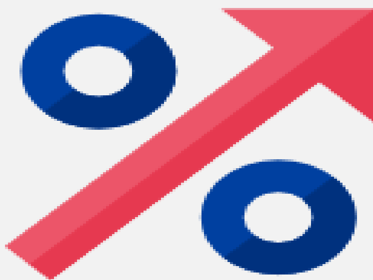
Currency futures were developed in 1972 by Chicago Mercantile Exchange Chairman Leo Melamed, working in concert with the Nobel Prize winning economist Milton Friedman. This development represented the first financial futures contract ever successfully introduced.

Over the years, many currency contracts have been added and the listings now include contracts on many currencies like ERU, GBP, JPY, CAD, INR, etc. For example, in India, Currency Futures traded at domestic exchanges are quoted in INR and cross currencies. USDINR, GBPINR, EURINR, and JPYINR are INR pairs whereas GBPUSD, EURINR, and USDJPY are cross currency pairs.

Futures vs. Forwards

Futures may be considered akin to a forward contract, and are priced as such, except that they are traded at a regulated futures exchange and subject to standardized terms and conditions. Exchange traded currency futures have historically been distinguished from OTC FX transactions by their standardization vs. flexibility or customization available in forwards.

Margin Requirement



Organized futures markets have margin requirements, to minimize credit risk. There are two types of margin requirements: the initial margin and the maintenance margin. The idea behind the margin account is that the margin should cover virtually all of the one-day risk. This reduces both; one's incentive to default as well as the loss to the clearinghouse in an event of default.

A futures contract is marked-to-market daily at the settlement price. The settlement price is an exchange's official closing price for the session, against which all positions are marked to market. In a liquid contract this may be the last traded price, but for less liquid contracts it may be an average of the last few traded prices, or a theoretical

price based on the traded prices of related contracts or decided by the regulator like RBI in India.

Every favorable (adverse) move in exchange rates creates a cash inflow (outflow) to the margin account. In order to avoid the cost and inconvenience of frequent but small payments, losses are allowed to accumulate to certain levels before a margin call (a request for payment) is issued. These small losses are simply deducted from the initial margin until a lower bound is reached. The lower bound is the maintenance margin. Then, additional money should be added to the account to restore the account balance to the initial margin level. This additional money is usually paid in cash and if not paid then a futures contract would be squared off by the risk management system of a broker.

Currency Futures – a Hedging Tool

A hedger uses the futures markets to reduce or eliminate the risk of adverse currency fluctuations. Usually, hedging involves taking a position in futures that is the opposite either to a position that one already has in the cash market or to a future cash obligation that one has or will incur. Therefore, the position in the futures market will depend on the position in the cash market.

A short hedger is the one that takes a short position in the futures market (i.e. sell futures) to offset the expected loss in the spot market in an underlying currency. For example; an exporter expecting to receive in the future, a payment denominated in a foreign currency, say; an amount of USD 100,000 after one month, would take a short position in USDINR FUTURES. If there is any adverse movement in USDINR, i.e. If USD depreciates then the loss in the sport market would be offset by gain in the short position in USDINR Futures.

A long hedger is the one that takes a long position in the futures market (i.e. buy futures) to offset the expected loss in the spot market in an underlying currency. For example; an importer who is to pay an amount of USD 100,000 after one month, would take a long position in USDINR FUTURES. If there is any adverse movement in USDINR, i.e. USD appreciates then the loss in the sport market would be offset by gain in the long position in USDINR Futures.

Hedging with futures is very simple: one takes a position in a futures contract that is the reverse of the underlying (cash) position.

Currency Futures – a leveraged product

Currency Futures is an innovative financial instrument that is used by both hedgers and traders. Price movement in a currency is a catalyst in generating volumes and has drawn an interest of many. However, it is important to note that a derivative instrument provides leverage and this has a potential to magnify gains as well as losses. Hence, it should be traded with knowledge and caution.