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FINly

GLOBAL DISINFLATION

CURRENCY

DERIVATIVE

FIN STREET
...the path to Financial Excellence!

SIMSR

Contents

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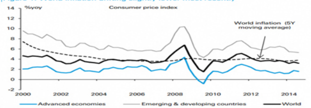
Global Disinflation

— Abhimanyu

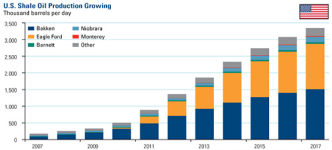
The scars of global downturn of 2008 do not seem to be healed yet. Poor demand in the emerging and developed economies coupled with technological revolution has increased the aggregate supply in the market, which has brought down the prices to nearly 1.4 percentage points. So, now the question arises WHY? Why economies across the globe is witnessing the same rare phenomenon of disinflation irrespective of their economic framework. The reason lies in the crust of the matter, which has undergone a tectonic shift i.e. Energy politics. By far any economy in the world is driven by its policies governing energy safety. Whether its BRICS or EU the economic policies are framed keeping the energy security in mind. Hence, it becomes imperative to understand the strategy behind this development.

Figure 1: World inflation drifting slightly lower most recently



Source: IMF, Deutsche Bank Research

OPEC, cartel of the world's largest oil producing nations which has the objective of keeping the oil markets stable, is now facing tough competition from none other than its biggest market i.e United States of America. Ever since the discovery of shale oil in US in 2011, there has been significant decrease in the demand for crude oil in the US, thereby disturbing the market equilibrium. The slow-down in Europe, China, India and Japan has also led to a decrease in demand for oil consumption thereby putting pressure on the OPEC to reconsider their strategy for the extraction corresponding to the demand. But as of now, OPEC under the leadership of Saudi Arabia has rejected any possibility of decreasing the production. The strategy seems to be that OPEC wants other high cost producers to get out of the business, which will automatically reduce the supply and let the prices to go up once again. United States on the other hand has developed more efficient Shale technology to extract oil at much cheaper rate, thereby signaling the possibility of better resource which is more economically viable. With the better technology available now, the monopoly of OPEC seems to be in danger and also the emergence of new strategic alliances.



Source: Woodmac, IEA, EIA, Reuters, company reports, BofA Merrill Lynch Global Commodities Research

So, far oil prices has gone down to 55$/b from 115$/b in June, which has greatly affected the inflation rates of the major oil dependent economies like India , China and Brazil and also to some extent the oil producing countries like US, Russia and Nigeria. Countries like India, whose import bill carries high weightage of crude oil, is on the happier side. Due to the decrease in global oil prices and the deregulations of diesel prices, the inflation rate (WPI) has touched zero for the first time and CPI has registered its lowest figures in the last 5 years. On the other hand China, which is witnessing its lowest decadal growth of 7 %, is on the poor demand side and due to the economies of scale available, increase in the aggregate supply has led to decrease in inflation figures to 1.4% which is the lowest. Both European Union and United States are still struggling to get out of their downward curve and has a weak demand coupled with downsizing risks with political, strategic and environmental concerns. Middle East has been under the spot light in the last decade concerning the political and business risk prevailing throughout the region and with the advent of changing energy dynamics, the volatility has further affected the expansionary cycle leading to weak demand.

Therefore, in totality the tussle between the economies of scale for energy (US) and the conventional players (OPEC) has been the driver of the global phenomenon of disinflation which is affecting different economies differently. But this changing economies of oil is going to have a positive impact as it will reduce monopoly and also provide the market with better substitute leading to more stability. So, The Central Banks and Governments have to hold on their cards until they see any significant happening and that too for consistent period of time, to make the impact.

Educational Section

–Shreya Devan

CURRENCY DERIVATIVES

What are Currency Derivatives?

A Derivative is any instrument which derives its value from an underlying. This underlying can be stocks, commodities, currencies etc.
A Currency Derivative as its name indicates derives its value from currencies or more precisely the currency exchange rate. There are various forms of currency derivatives, which have their own uses. The most important among them are Currency Forwards, Currency Futures, Currency Options and Currency Swaps.

Types/ Forms of Currency Derivatives

1. **Currency Futures**

A currency future is a contract wherein one currency is exchanged for another at a specified date in future, but at a price decided in present or the time at which purchase was made.
Most of these contracts have physical delivery, which means that people who hold these contracts till the end of last trading day receive payments in each currency. Investors also have the option to close their contracts any time before the delivery date of the contract.
A future contract of USDINR with expiry date 13th April, 2015 will be represented by the symbol 'FUTCUR-USDINR-13APR2015'.

Benefits of Currency Futures

- **Hedging:** Currency Futures are used by investors to hedge against foreign exchange risl For example, Roy is a US-based investor who will receive Rs. 1, 00,000 on December 30. The exchange rate fixed currently by the futures is Rs. 60/$. He can lock in this exchange rate by selling future contract of Rs. 1, 00,000 expiring on December 30. By doing this, regardless of fluctuations in the exchange rates of Indian Rupee and U.S Dollar, he is guaranteed an exchange rate of Rs. 60/$.

- **Speculation:** Currency futures can also be used for the purpose of speculation. By incurring a risk, speculators attempt to profit from rise or fall in exchange rates.

2. Currency Forwards

A currency forward is an agreement to buy foreign currency on a specified future date at an exchange rate decided in the present. This helps in removing uncertainty as to how much future receivables or payables will be worth in terms of domestic currency.

If the forward price of a currency exceeds spot price, then that currency is said to be at a premium. For example, spot price of sterling in terms of U.S dollars is 1 Sterling = $ 1.57 and the six month forward price is 1 Sterling = $ 1.80, then sterling is said to be at a premium.

Whereas if the six month forward price is 1 Sterling = $ 1.40, then sterling is said to be at a discount.

A major benefit of currency forwards is that the contract can be tailored to a specific amount and delivery period according to your needs, unlike currency futures which are standardized. Also there is no centralized trading location for forward transactions and these are conducted directly between parties through telephone conversations and online trading platforms.

Difference between Currency Futures and Forwards

Currency futures have standard time periods, settlement procedures, contract sizes, and are traded on regulated exchanges, whereas currency forwards may have different contract sizes, time periods and settlement.

3. Currency Swap

A currency swap is a contract between two institutions to exchange the principal and/or interest payments of a loan in one currency with principal and/or interest payments of a loan in another currency. Both the loans should have equal net present value at the time of exchange.

It should be differentiated from an interest rate swap wherein there is exchange of interest rates only, not principal amounts.

Benefits of Currency Swap

Currency swaps are used by borrowers to reduce their cost of debt. They borrow at the cheapest rates regardless of the currency at which the loans are available and then swap them to their domestic currencies.

4. Currency Options

One of the most complex instruments, currency options are agreements which gives the owner a right, but not an obligation to buy or sell a foreign currency at a specified exchange rate at a certain time in the future. People prefer options because it is a lot more flexible than forwards or futures, but this flexibility comes with a cost. The buyer of options contract needs to pay a premium or fees for this right. If the owner obtains the right to buy the currency it is known as call option and if it is to sell the currency it is called a put option.

Benefits of Currency Options

The biggest benefit is that if there is a favourable movement in exchange rate, then he/she has the choice not to exercise the option and profit from the favourable movement. This option is not available to the investor in case of any other derivative.

Participants in Currency Derivative Market

In a currency derivative market, there are some common players who undertake transaction depending upon their motives:

- Traders

Importers as well as exporters are exposed to currency risks because there is a time gap between finalizing an import/export order and making/receiving payment. As this gap widens the possibility of exchange rate fluctuation increases. To safeguard themselves from this exchange rate fluctuation risk traders use currency derivatives.

- Arbitrageurs

An Arbitrageur buys and sells currency pairs from different brokers whose offer differs and they take advantage of this difference.

- Speculators

A speculator is one who participates in risky financial transactions to make profits from exchange rate fluctuations.

Currency Derivative Market in India

Various forms of currency derivatives have been traded in India from the 1990s itself. In 2003, currency options were formally introduced. Currency forwards and swaps are also widely used in India. The National Stock Exchange (NSE) introduced currency futures in 2008 and Bombay Stock Exchange (BSE) introduced it in 2013. Faced with growing competition from BSE, NSE recently announced discounts of up to 50 per cent in transaction charges for trading on its currency derivatives platform. The third major player in this segment is MCX Stock Exchange (MCX-SX).

The Exchange Traded Currency Derivative market is regulated by Security and Exchange Board of India (SEBI) through the recognized stock exchanges. The Foreign Exchange Management Act (FEMA) is the law, which regulates the Foreign Exchange market and the regulatory authority for the Indian Foreign Exchange Market is the Reserve Bank of India (RBI).

The Indian derivatives market is continuously evolving. An evidence of this is that in the last five years, the Indian currency derivatives market has grown by over 1,550% in terms of daily average turnover. Despite all this we have a long way to go towards becoming a fully developed currency derivatives market.

NEWS BUZZ

- Nirali

Troubled Spice Jet experiences a slip in market share

The airline has cancelled over 2000 flights by returning planes to lessors because it couldn't pay. Spice Jet operations were grounded as oil companies stop fuel supply. It's fleet size has fallen drastically since the turn of events and its share prices have plunged as much as 8.2% in trade. Loan guarantees from promoters seem to be a ray of hope to revive itself.

Fall in Brent crude prices to $59 per barrel

Firm decision by OPEC not to cut back on its production to prop up prices is upending our global economy. Low prices of gasoline have been welcomed by oil consumers such as US and Japan but countries reliant on oil sales are facing the brunt. Russia's economy is melting down.

RBI's Monetary Policy

RBI Governor Raghuram Rajan resisted calls for rate cuts despite pressure. Containing inflation and reviving investment and growth are some of the decision taken. Repo rates were kept constant at 8%.

NMCL industries' IPO on 29th December

NMCL industries plan to hit the capital markets with an offer for sale of 60 lakh equity shares through an initial public offering. The price band has been fixed at Rs 100 to Rs 120 per equity share of Rs 10 each. They are proposed to be listed on BSE and NSE.

Goods and Service Tax (GST) scheduled for April 1 , 2016

The levy seeks to replace multiple central and state taxes on goods with a single tax that will create a unified national market. The Centre will compensate states for any loss of revenue arising on account of implementation of GST for a period of 5 years.

PSU Banks write off loans worth Rs 1,06,170 crore

The amount of bad loans written off or restructured by the public sector banks has more than doubled in the last three years ending at Rs 42,447 crore in 2014. The rise in bad loans is being attributed to slowdown in the economy which slipped to below 5%. The government has advised public sector banks to constitute a board level committee for monitoring of NPA (Non-performing asset) accounts and recovery.

Flexibility to Regional Rural Banks (RRB) to raise capital

A bill was passed by the Lok Sabha to raise the authorized capital of RRB's to Rs 2000 crore and enable them to mop up funds from the capital market. This move will help deepen financial inclusion to the existing 56 RRBs and will pave way for privatization of the RRBs.

Fall of the Russian Rouble

Russia suffers the worst fall since 1998 crisis amid fears over the impact of tumbling oil prices on the country's economy. It hit a record low of 53.86 per dollar – a move of 6.5%. The effect of the rouble's slide has been mixed. Russian resource exporters earn revenues in dollars but most of their costs are in roubles so the currency's decline has cushioned some of the impact of the oil price's fall. However, it has also strangled investment in an economy highly dependent on imports for everything except natural resources.

TRIVIA

- Tamoghna

Morgan's Christmas Connect

JP Morgan's uncle James Pierpont wrote "JINGLE BELLS" in 1857

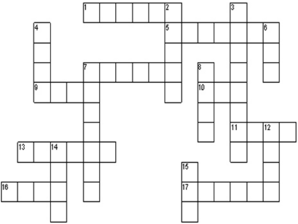
The First First

Martha Washington was the first first lady to appear on U.S. currency. She appeared on a $1 silver certificate in 1886 and 1891, as well as on the back of the $1 silver certificate in 1896

A Clean Chit

In Japan, there is an ATM machine that heat presses each bill at 392 degrees for one-tenth of a second before it's dispensed and what you get is a clean bill.

FINANCE CROSSWORD



Across	Down
1 obtain money that you must pay back	2 spend carelessly
5 a place for money at the bank	3 money used in a country
7 use money to make interest or profit	4 a place to keep valuables
9 receive money in exchange for work	6 small amount given for services
10 be in debt	7 receive from a person who dies
11 coins or notes	8 money that you must return
13 money earned monthly or annually	12 keep money for future use
16 a piece of metal used as money	14 give money which will be returned
17 total money received	15 obtain money by chance

Answers:
Across: 1)Borrow, 5)Accont, 7)Invest,9)Earn, 10)Owe 11)Cash,13)Salary, 16)Coin,17)Income
Down:2)Waste,3)Currency,4)Safe,6)Tip,7)Inherit,8)Loan,12)Save,14)Lend,15)Win

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