ABSTRACT

The Global Financial Markets have undergone drastic changes due to higher mobility of funds across borders. I have been observing the trends in the markets since 1992 & over time I soon came to see that the financial markets were getting highly correlated across borders. This became even more obvious during many periods such as the dotcom bubble in 2000-01 & the Financial Crisis of 2008. Since 2008 risk aversion seems to be paramount amongst investors of all types – small or big. Investors tend to seek safer returns & would want to limit their risk levels. Hence investors in the currency markets hedge their position to protect themselves against the risks of exchange rate fluctuations. Exchange rates are influenced by a plethora of variables such as interest rate differentials between the countries' currencies, economic variables such as GDP, Exports etc.

One of the key factors is the interest rate differential as mentioned above between the respective country currencies. Given this factor & the evolution of many instruments which allow for investments in currencies investors have over time started borrowing currencies with low interest rates & invest such funds in assets with higher yields. This is known as the carry trade. When they do such borrowing in the Foreign Exchange markets there is always the exchange rate risk. Given the concepts or theories of no arbitrage, interest rate parity (covered, uncovered) an investor's returns is limited by the future appreciation of the currency that he/she has borrowed vis-à-vis the other currency. This means that the forward rate of converting from one currency to the other which has been borrowed eradicates all the profit from the transaction. But in actual practice there is a breakdown in the uncovered interest rate parity concept wherein the currency which is being borrowed known as the funding currency depreciates against the other currency known as the target currency. There have been many empirical studies that have actually evidenced the appreciation of the target currency against the funding currency making the carry trade more profitable.

Historically the Japanese Yen with its very low interest rate has been a popular funding currency, the YEN-US Dollar has been one of the most preferred (favorite) carry trade pair. And in the recent past with the US Federal Reserve bringing down its interest rate following the 2008 financial crisis the US Dollar also has become a funding currency against higher yield currencies such as the New Zealand dollar, Australian dollar etc. Hence this phenomenon of the carry trade has allowed investors to channel funds into other asset classes such as equities, commodities etc. This in turn increases liquidity flow into the stock markets which makes the stock markets go higher up. This is the hypothesis of the current study – to understand the causal relationship between the carry trade activity & the emerging countries stock markets. Technically, causation is used in the sense of forecasting.

The carry trade is represented by the Deutsche Bank Currency Future Harvest Index (DBCFH) which is the most tracked index for the world carry trade. And the stock market is modeled by the Indian Stock Index NSE NIFTY. The study evaluates the causality between carry trade activity and stock market performance or vice-versa through the VAR based Granger Causality framework. In other words does carry trade granger causes stock market? Or stock market granger causes carry trade?

The horizon for this study is from the start of 2005 to the end 2009. From the study it's found that the direction of the causal relationship is from the carry trade to the stock market and not the other way.