ABSTRACT

The emergence of derivatives in the financial markets has raised much debate regarding its effectiveness in stabilizing spot currency markets of emerging economies. While some authors staunchly support the introduction of derivatives in order to reduce spot volatility through low transaction costs and hedging opportunities; others contest this theory by arguing about the influx of speculators into the market. Recent interest in futures contracts on emerging market currencies has raised concerns among some central bank authorities about their ability to maintain stable currencies.

This paper presents empirical results examining the influence of the Indian Rupee and the Chinese Yuan futures contracts on the respective spot markets. To explore the time series properties Unit Root Test and ARCH LM test have been employed and to study the impact on underlying volatility GARCH (1, 1) model has been employed.

The results indicate that the introduction of currency futures trading has helped in reducing the exchange rate volatility of the foreign exchange market in India and China. However, the Chinese decline has surpassed the Indian decline by a huge margin. Further, the results are also indicative of the fact that the importance of recent news on spot market volatility has decreased and the persistence effect of old news has declined with the introduction of currency futures trading.

Keywords: Currency Futures, Exchange Rate, Forex Market, GARCH, Volatility.