ABSTRACT

Interest rate futures trading has been introduced in developed markets several decades ago to manage interest rate risk. This was never a problem in India as we had administered interest rates. The financial sector reform in the 1990s has caused a paradigm shift. This study explores the link between the future spot prices and today's future prices, leading to the valuation of Indian interest rate futures contracts. The results show that sixty three percent of the evolution of spot prices is influenced by the expectations in today's future prices of the Indian interest rate futures contracts. Asymmetry in the private information among the players in the Indian interest rate futures market causes an implied volatility, of up to thirty seven percent, explaining the expectations mismatch between today's future prices and future spot prices of interest rate futures contracts in India.