ABSTRACT

After the world shifted to the floating exchange rate system, one of the most important quests for economists has been to predict the exchange rate accurately. Researchers have used unbiased forward rate hypothesis and rational expectations to determine spot exchange rates. Though the literature uses both these theories to explain spot exchange rate movement, most empirical research find that forward or future rates have little predictive power in forecasting future spot rates. Conditional on the hypothesis that the currency future market is efficient, the purpose of this paper is to study the evolution of the Indian currency futures market and evaluate empirically the validity of expectations hypothesis for the Indian foreign exchange market using future exchange rates for four currencies – US dollars, Great Britain Pound, Japanese Yen and Euro. The evidence obtained by the spot and future exchange rate data for four currencies indicates that though future rate is a reasonable predictor of the future spot rate, it does not capture all information available to economic agents. This variance in exchange rate can be attributed to the risk premium which incorporates the uncertainty about the influence of macroeconomic factors and lagged effect of news.