Zeroing in on the Aspects of Cross Currency Trade in India

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***Abstract*: Currency trading is gaining momentum and getting recognition from traders and investors. No wonder globally, currency trading is a larger market than trading and commodity market combined. Currency traders from all across the world use a highly professional inter-bank market comprising of electronic trading platforms to connect, exchange currencies and influence the foreign exchange.**

In India, this concept is now emerging as one of the most significant platforms for trading. More and more investors are now interested in trading in the currency market. Currency trading refers to the activity where one trades in a pair of currency and get gains through the fluctuation in its prices.

The skyward trend for currency trading in India started with the introduction of future derivatives in Forex. This opened the avenue for individual investors unlike before when it was only open for financial institutions, banks and corporate entities. Liberalization has aided banks and corporates in getting freedom and flexibility to retain and trade in foreign currencies. As the trading regulations were softened, it gave rise to the integration of local and global economies.

Trading in the currency market in India happens on the National Stock Exchange (NSE), Bombay Stock Exchange (BSE) and Multi Commodity Exchange (MCX) and is monitored thoroughly. This research paper aims to demonstrate the need for introduction of more currencies for cross currency trading in India.

The objective of this research is to discuss the current scenario of cross currency trading in India along with the pros and cons of such trading. The methodology used in this research is qualitative in nature and the paper relies on the secondary data. On completion of this research it can be seen that India is still behind the developed countries in the field of cross crossing trading and there is a lot of scope for the Indian businesses to expand by using cross currency pairs.

***Keywords*: Cross currency in India, Currency Trading, Forex cross pairs, Currency Derivatives.**

1. Introduction

A. Meaning of Cross currency and Cross currency pairs

In India, a cross currency refers to a currency pair in which the Indian Rupee (INR) is not involved. A cross currency transaction doesn't use the Indian Rupee as a contract settlement currency. Common cross currency pairs involve the US Dollar, the Pound, the Euro and the Japanese Yen. (ET Markets, 2018) So the cross currency trading is available in various pairs and are normally traded between a hard global currency like the US dollar (USD), UK Pound (GBP), Euro (EUR) or Japanese Yen (JPY) and the Indian Rupees (INR) on the other side.

Indian Rupee	1.00 INR	inv. 1.00 INR
US Dollar	0.014083	71.007226
Euro	0.012730	78.553083
British Pound	0.010960	91.237136
Australian Dollar	0.020495	48.792580
Canadian Dollar	0.018583	53.812118
Singapore Dollar	0.019149	52.220789
Swiss Franc	0.013977	71.543816
Malaysian Ringgit	0.058373	17.131123
Japanese Yen	1.531369	0.653010
Chinese Yuan Renminbi	0.098807	10.120691

Fig. 1. Top 10 currencies exchange rates as on 07/11/2019, 11.53 AM IST.

B. Users of Cross currency pairs

Let us take the example of an India company which imports from France and then exports to the US. This company will have exposure to the US Dollars (USD) and to the Euro (EUR). Since the company is importing from France it will have to protect against strengthening Euro. So it will have to buy a EUR-INR pair. At the same time, since the company is exporting to the US it will have to protect against a weakening dollar. So it will have to sell the USD-INR pair. (Tradeplus Updates, 2019) An easier way would be to just buy the EUR-USD cross currency pair. The company is automatically hedged against the strengthening of Euro and also against the weakening of US dollar. This is the utility of cross currency pairs. So, Cross currency pairs are used in businesses and also the trading of cross currency pairs is a business as traders to it to earn profits from the price differences.

C. Brief History of Cross Currency Trading in India

Currency trading has evolved over the years. The exchanges in India (NSE, BSE & MCX) started launching the currency futures trading from the year 2008. Currency futures on USD-INR were introduced for trading and subsequently the INR was allowed to trade against other currencies such as RUE, GBP and JPY. Currency Options was introduced in the year 2010. Further, Options trading on EUR-INR, GBP-INR and JPY-INR was also introduced in February 2018. Cross Currency Futures

and Options contracts on EUR-USD, GBP-USD and USD-JPY are also introduced in February 2018. (NSE India, 2019) The most active cross currency pairs in India are those that make up the major currency pairs.

Currency Pair	Base Currency	Quote Currency
EUR USD	EUR	USD
GBP USD	GBP	USD
USD JPY	USD	JPY

Fig. 2. Currency pairs available for Futures & Options trading in India

The US dollar, UK Pound, Euro or Japanese Yen are the currencies that when traded against the Indian Rupees are referred to as major currencies in India. Major currency crosses such as the EUR-INR, or the USD-INR provide traders with robust trading liquidity.

2. Analysis

A. Highly Correlated Trading Pairs

Generally, countries that are economically intertwined have currencies that move alongside each other. One can consider trading this type of currency pair in two ways. Highly correlated trading pairs offer opportunities to range trade using technical indicators such as the Bollinger bands, the Stochastic or the relative strength index. (Forex Trading, 2019) Alternatively, one can look for periods when stability has set in and an unexpected event is likely to provide volatility.

The upside to trading some highly correlated cross currency pairs is they offer great liquidity in most time zones. One should expect the bid offer spread of highly correlated major pairs to be relatively tight and provide ample liquidity to enter and exit the positions.

B. More Trading Instruments

One major benefit of utilizing cross currency pairs is that these instruments produce more opportunities to trade by increasing the breath of available trading instruments. If one are only trading the major currency pairs, there will be 4-different securities to generate a trading view. If cross currency pairs are added to the mix, few more different combinations will be generated to express the forex trading view. Experienced traders are constantly looking for opportunities within cross currency pairs (Investopedia, 2019). By adding cross currency pairs to the arsenal of instruments, the door to a wide range of products that provide sufficient volatility to formulate and incorporate the trading strategy opens.

C. Similar to Pair Trading

Another benefit of trading cross currency pairs is that cross pairs provide the opportunity of buying along with selling the strongest and weakest currencies that exist in the market (Forex Trading, 2019). The concept is similar to pair trading as it is an attempt to find securities that are poised to gain, along with securities that are poised to underperform.

D. Settlement Might not be So Simple

The settlement of a cross pair trade is not as simple as the actual transaction. Since there is ample liquidity on a major cross trade, most brokers execute the trade using a relatively tight bid offer spread. But, when one exits the position the profits could be in a currency that is not his or her home currency (Reddy, 2019). For example, when one's home currency is INR and one has a successful EUR-USD trade, the profits could be in dollars, which now needs to be trade back into Indian Rupees. This again involves conversion of currency.

E. Cross Currency Spread can be wider

While nearly all of the major currencies provide adequate liquidity with minor transaction costs, cross currencies, could be costlier to trade. This is generally not the case for a currency such as the EUR-USD, but if the trade is in a currency pair where liquidity is weaker, one will likely have to pay a little more to enter and exit each trade. Additionally, currency pairs that experience volatility against the dollar are also likely to see higher volatility as a cross pair. With these type of crosses, the bid offer spread will be wider.

The time zone and trading session where one places the transaction needs to be considered when trading forex currency crosses (Motilal Oswal, 2019). During early Asian hours, many of the European crosses and the UK Pound have weak liquidity. To protect themselves from low liquidity, forex brokers will charge a larger than normal spread to make a market in a cross that is not liquid in their time zone.

Many Forex brokers make money by taking advantage of the bid offer spread in cross currency trades. The difference between the sale price and the purchase price is the spread and this is the incremental value, which the broker uses, to make money from transacting cross currency trades (Sincere, 2019). Generally, there is some risk involved in their own making a market for such trades but if a broker makes a price and can exit the trade with back to back transactions, then there is no market risk.

For example, if market making broker ABC, quotes a EUR-GBP rate of 0.8601 – 0.8604 to their client on a forex order, but receives a quote from their liquidity provider at EUR-GBP 0.8602 – 0.8603, they can exit with a gain. If a back to back situation does not exist, the market maker may need to hold the position for some time and be exposed to some market risk.

Bid Price (price at which you buy)	Ask Price (price at which you sell)
1.2431	1.2429
1.2429	1.2427
1.2425	1.2222
1.2420	1.2418
1.2418	1.2416

Fig. 3. Example of a typical order book for EUR-USD pair

F. Effect of Interest Rates of the Economies

The currency markets are generally driven by interest rates of the economy over the long term. Higher relative interest rates

of the economy attract big institutions and investors to the currency. Investors have to face the question, when they evaluate a currency pair, as to which currency will provide income if the market does not move. The carry is a term that describes whether the interest will be earned or be paid when the transaction takes place. The currency with the higher interest rate will earn what is referred to as the interest rate differential or the carry as described above.

Each country has its own sovereign interest rate. For example, the Japanese Government Bond has a specific interest rate based on the value of the bond. The British 10-year bond also has an analogous interest rate. If the yield on the British 10-year bond is higher than the interest rate on the Japanese government bond, one would earn the difference between the two interest rates if one purchases the GBP-JPY with a settlement date in 10-years (Forex Trading, 2019). Obviously, most cross currency traders do not plan to hold a currency transaction for 10-years, but the concept exists for any period beyond spot.

G. Cross Forward Point Spread

One of the drawbacks of trading cross rates for a period beyond spot is being subject to a bid offer spread for the forward points. Not only one is likely to pay a larger bid offer spread on the spot cross currency transaction, but also one is likely to pay a greater spread when rolling the spot cross currency rate out to a date beyond spot (Forbes, 2017). If this process is done multiple times during the life of the trade, the spread can erode a portion of the profits that was forecasted.

H. Benefit of Fundamental Analysis

It is helpful to analyze economic data when trading cross pairs, as the interest rate differential could play a role in determining the future direction of the currency pair (Kotak securities, 2019). The process of evaluating the interest rates and other relevant economic data points is often referred to as fundamental analysis. When reviewing economic data for a specific country, it is important to investigate and determine what factors are contributing to economic growth and how that growth will impact the country’s economy moving forward.

Usually, when a country’s economy is doing well, the demand for the country’s currency and the resulting exchange rate should be expected to rise in value. On the other hand, if a country’s economy is underperforming and producing weak economic data the demand for that country’s currency might decline. Using fundamental analysis, it is possible to analyze the correlation between economic data and the value of a country’s currency.

I. Risk of other factors

Usually traders take for granted the stability of the U.S. economy over other countries’ economies (Forbes, 2017). Cross pairs have an added layer of risk because instead of evaluating the political and financial instability on one country vs the US dollar, one will have to analyze two other economies against each. Not remaining focused and updated can sometimes wreak havoc on the positions. If one is not in tune with the political and economic conditions within the countries of the currencies one is evaluating, such an evaluation might go completely wrong.

J. Exotic Cross Currency Pairs

Currency pairs are loosely broken down into multiple categories - major currency pairs, major cross pairs, minor currency pairs, minor cross pairs and exotic currency pairs.

Exotic currency pairs are currency pairs that are not relatively less traded in the foreign exchange market. Usually, exotic currency pairs are those from developing countries such as areas of Asia, the Middle East, South America and Africa. These pairs generally have large bid offer spreads and usually require a longer term strategy where the profit projections significantly exceed the bid offer spread.

Ticker	Currency Name
EURMXN	Euro vs Mexican Peso
EURRUB	Euro vs Ruble
USDCNH	Dollar vs Yuan
USDMXN	Dollar vs Mexican Peso
USDRUB	Dollar vs Ruble

Fig. 4. Examples of Exotic currency pairs

One of the pros of trading exotic cross currencies pairs is that the yield differential is in favor of the less stable currency (Forex Trading, 2019). One gets paid to hold on to a currency that can be volatile, and unstable. This type of strategy is very alluring but can be quite risky.

As an aside, when a country has a relatively weak currency, their goods and services are inexpensive relative to its competitors. This can be very attractive for a central bank that is attempting to spur growth. Many times a country ties its currency to other countries’ currencies, and avoid having its currency float, to avoid appreciation, which can reduce export growth (Aleksandarboric, 2018). If a country pegs its currency to other currencies, the central bank usually manages the daily trading activity that keeps the currency in line.

An example of this scenario used to be the Thai Bhat (Forex Trading, 2019), which pegged its currency to the yen, dollar and Euro. This peg was in place until 1998, when the Thai government decided it was too expensive to hold the peg to other currencies. Prior to this period, a strategy that was used by some traders was to purchase Thai Bhats and simultaneous sell the USD, EUR and JPY to earn an interest rate differential. This is considered a type of carry trade. When the peg was finally broken, the currency tumbled and many traders lost millions of dollars.

3. Conclusion

Currency prices go through a lot of fluctuations as they are

affected by various economic and political factors. Other than such factors, they are also affected by interest rates, inflation, and international trade. The government can influence the value of INR in the foreign exchange market. They can do this with the intervention of the RBI. Big corporates can also impact currency trading in India with huge market orders. If a country experiences an upscale trend in export earnings, then there is an increase in its foreign exchange supply as well. These interventions can lead to high fluctuations in currency prices and in turn for currency trading in India. Yet, given the size of the currency market in India, it is not easy for an individual company or body to single-handedly impact the market for a long period of time. Currency trading is a significant contributor to India's economy and will keep on increasing.

While there are a number of costs associated with trading cross currency pairs, expanding into this domain will provide a number of opportunities of expansion to the Indian economy. By adding more currencies for trade, other cross currency pairs that are on the move will also be accessible, ultimately favoring the economy's growth. This will be beneficial for trade, since people, who want to convert their currencies, no longer will have to convert them first into USD and then into the INR. With the advent of electronic trading systems, cross currency pair trading is flourishing in India. Exotic cross currency pairs can be relatively unpredictable and highly volatile, sometimes well beyond the historical volatility that can be experienced by trading the major currency pairs. Introduction of such pairs will generate more trading opportunities. Cross currency pairs can make international transactions easier and cheaper if more currencies and pairs are introduced by the SEBI. While the trading risks and costs can be higher, the benefits of adding the more liquid cross currency pairs to the Indian economy are worth it.

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