

## CURRENCY DERIVATIVES



vEcoSys

**Understanding**  
**'Currency Derivatives'**  
– By Prof. *Simply Simple*™



## CURRENCY DERIVATIVES

One of the most exotic terms  
in derivative trading is  
'Currency Derivatives'.





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**But what are currency derivatives?  
And how are they transacted?**

**Let me try & simplify the term for you  
over the next few slides...**



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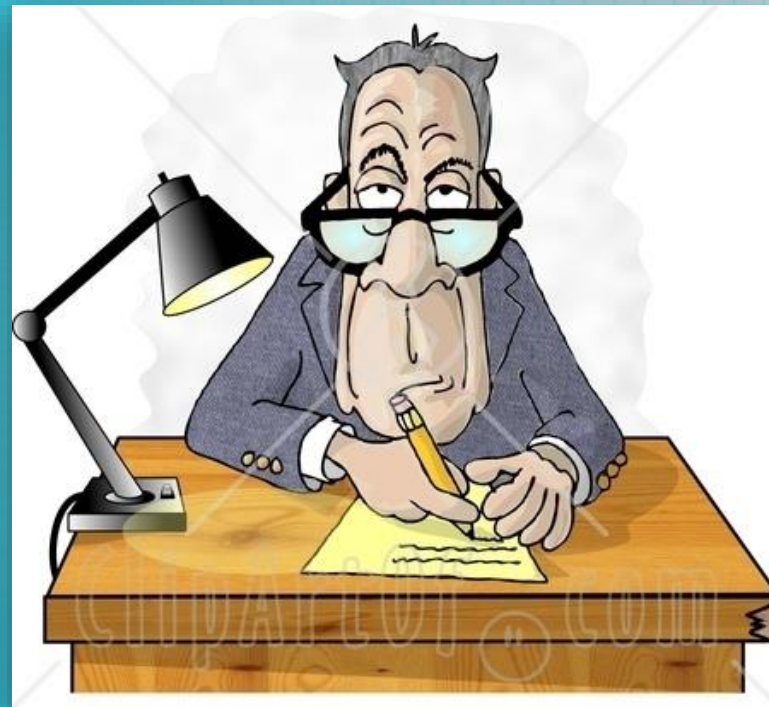
Let's say there is a farmer who grows tea in India, which is exported to the USA.



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And there is an importer of tea in the USA.

Let's assume the current rate of exchange is Rs. 45 for 1 USD.





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Assume that the tea grower agrees to supply 10 quintals of tea to the importer at 10 dollars a quintal three months down the line upon harvesting.

(1 Quintal = 100 kgs)

It is important to understand that the importer buys tea at 10 dollars a quintal, no matter what the exchange rate is.



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- ❑ The tea grower thinks that the rate of exchange, which is currently trading at Rs. 45 to a US dollar, could fall to Rs. 44 in 3 months.
- ❑ This means that while the importer would pay her 100 dollars ( $\$10$  per quintal  $\times$  10 quintals =  $\$100$ ), she would earn only Rs. 4400 ( $\$100 \times$  Rs 44 per dollar) instead of Rs 4500 ( $\$100 \times$  Rs 45 per dollar) thus incurring a loss of Rs. 100. ( $\text{Rs } 4500 - \text{Rs } 4400$ )





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- ❑ So the tea grower goes to a currency trader and signs a 'forward contract' which says that at the end of 3 months the currency trader would hedge her against a possible decrease in exchange rates.
- ❑ This means that, at the end of 3 months, the currency trader would pay her Rs. 4500 for her 100 USD, no matter what the prevailing exchange rate.



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Such a contract is called a 'Currency Derivatives' contract because it is a currency contract that has to be executed at some future date.



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Now, let's look at 3 different scenarios:

Say that after 3 months the rate of exchange remains Rs. 45 to a USD.

In this case the farmer will take the 100 USD she has received from the importer & go to the currency trader.

The trader will pay her Rs. 4500, as per the contract.

So the tea grower makes Rs. 4500 in all.





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Now, let's look at the 2<sup>nd</sup> scenario:

Say that after 3 months the rate of exchange reaches Rs. 46 to a USD  
(i.e. \$100 = Rs 4600)

In this case the farmer's call was wrong. She will take the 100 USD she has received from the importer & go to the currency trader.

The trader will pay her Rs. 4500, as per the contract and would sell off the 100 USD in the market for Rs. 4600, thus making a profit of Rs. 100.



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Now, let's look at the 3<sup>rd</sup> scenario:

Say that after 3 months the rate of exchange drops to Rs. 44 to a USD.

(\$100 = Rs 4400)

In this case the farmer's call was right. She will take the 100 USD she has received from the importer & go to the currency trader.

The trader will pay her Rs. 4500, as per the contract thus incurring a loss of Rs. 100.



## CURRENCY DERIVATIVES

Thus, while the tea grower may not make any profit if the rupee becomes weaker against the dollar, she will definitely profit if the rupee appreciates & drops below Rs. 45.

But at least she would have been at peace for the period of 3 months since she remained protected against any kind of fall in the rupee.





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Hope you have now clearly understood the meaning of 'currency derivatives' and its practical application.



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Hope this story succeeded in clarifying the concept of 'Currency Derivatives'

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