

Exchange Rates and Forward Premia in Indian Foreign Exchange Market: A Study of USD/INR

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The study attempts to identify determinants of USD/INR forward premia. It is based on Multiple-Regression analysis and uses monthly data from December 1998 to March 2011. The results suggest that Interest Rate Differential (IRD of MIBOR–US LIBOR), Crude Price, Net Intervention of RBI, lagged values of forward premia, turnover in the foreign exchange market and IRD are the most significant variables in determining USD/INR forward premia. Primary data have been collected through a questionnaire from 211 professionals across the world. The survey suggests that Indian foreign exchange market has become deep, liquid and efficient over a period of time. It is unanimously agreed that forward contracts play an important role in addressing the exchange rate risk of exporters, importers, borrowers and investors. Most respondents agreed that forward premia influence future exchange rates. Qualitative attributes like market sentiments, expectations, political stability and financial news play a vital role in determining forward premia.

I Prologue

Exchange rate is the price of one currency in terms of another. Foreign exchange markets are one of the most continuous and the largest financial markets in the world. Participants are exposed to fluctuations in exchange rates on a continuous basis. Hence, they regularly plan to have adequate *cushion pads* for the exchange rate risk. A mechanism to offer protection in such a situation is the use of forward market. Forward contracts play an important role in addressing exchange rate risk of the market participants, viz., exporters, importers, overseas investors and borrowers in foreign currency.

If foreign currency is available at a cheaper rate in the spot market than in the forward market, it is quoted at premium. If the foreign currency is costlier in

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