

# Free essay on definition

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## **Abstract**

A key feature of modern financial markets is extreme volatility. This is as a result of frequent and almost unpredictable fluctuations in the prices of foreign currencies, financial instruments, as well as imports and exports. This majorly leads to uncertainty in business, and in most cases, huge losses as a result of negative market and currency movements. In order to reduce such risks, a number of tools are available that can be utilized, in a process called hedging. Derivatives, therefore, are some of the widely used methods of hedging. This essay seeks to define derivatives, as well as explain the common types of derivatives, and how they can be used for hedging purposes.

The objective of derivatives is to reduce uncertainty in returns, as well as to minimize the risks that are inherent in business transactions especially in an international or multicurrency arena. They are therefore defined as products that derive their value from another underlying asset, or the characteristics of such other asset. While derivatives are commonly used for hedging

purposes, they can also be used for speculation, a practice that is prohibited in some countries (Clifford, 1994). The most common types of derivative contracts include the futures, forwards, options and swaps. For the purpose of this essay, we shall explain the future and forward contracts.

### **Forward contracts**

A forward contract is an agreement between two parties that requires the delivery of a given amount of foreign currency at a specific future date, by one of the parties in exchange of a given amount of domestic currency, at a specific and pre agreed price. For instance, two parties agree to exchange dollars for Euros at a specific date in the future. On the given date, each party has to honor their part of the bargain, regardless of the prevailing exchange rates. In many countries, forward contracts are very much regulated so as to reduce instances of speculation and arbitrage in the Forex markets. For example, in countries such as India, banks are only allowed to offer forward cover in cases of genuine imports and export transactions.

### **Futures contracts**

These are derivatives that are quite similar to the forward contracts. In fact, the only major difference between these two is the mode of trading as well as standardization of the transactions. By definition, therefore, a futures contract is a contract between two parties, to transact in a specific asset of a given standardized amount for a pre agreed strike price, with the payment or delivery expected to happen at a specific date in future. The transaction is generally negotiated at an organized market, generally called the futures market. The purpose of the exchange market is to act as an intermediary, so

as to mitigate the risks of default by either of the parties. This therefore requires the parties to deposit a given amount of money with the futures exchange market, so as to ensure that the parties do not default in the transaction (Stout, 2001)

## **Conclusion**

There is so much that can be written about derivatives. Most importantly though, is the fact that derivatives are very important tools in modern day finance, and especially international trade. This is because, they enable traders to remain certain of their returns, while at the same time reducing or managing their losses which would otherwise be maximized without the intervention by the use of these hedging tools. It is therefore quite imperative that traders understand the operations of these tools, as well as the foreign exchange markets so as to ensure a profitable utilization of derivatives for the benefit of international trade.

## **References**

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