Hedging forward the sales or purchases of

Economics, Currency

Hedging – It is the action taken to reduce the riskiness of the future (undisclosed) price shifts in a commodity (tea, turmeric , etc.), financial safety (equity, stock etc.

) also foreign currency. Therefore it can be undertaken to forward the sales or purchases of the commodity, security or medium of exchange in the forward market; it can also be done by bringing out a choice which minimizes the option for the holder’s introduction to price alteration . It avoids the risk of price shifts and finds solutions in the transaction , on the other hand speculations predicts that the risk of price changes by taking one position (either long or short) in market, and cease the price of commodities to proceed in “ their” way. Hedging, simultaneously, has a perspective, either long or short, mostly this is the case in the cash market, and aims to limit the risk of price shifts loss by entering in an opposite and roughly equal position in the second market (usually futures or options).

For example, if a manufacturer of copper wires assumes a rise in the price of copper in the upcoming three months, he will bring a position in the futures market which is at current prices to balance the likely price increase. Likewise, if the prices are falling, he will sell in the futures market in the current prices against the physical goods . Every big buyer, seller and processor of commodities needs to hedge against price volatilities round the year. Although year round price variation can be anticipated, the force of volatility cannot be predicted. Besides, there are various factors apart from the seasonality which causes price volatility.

Thus, there is a continuous need for hedging. All big buyers, sellers and processors and users of commodities need to hedge reason being they all stand unguarded to price volatility. They comprise: commodity producers, big consumers, manufacturers for whom a commodity is major raw material, processors of commodities, importers, exporters, traders, etc . In case of futures, the party hedging would have to reimburse margin – some percentage cost of the contract value (usually in the of 5-8%). For choice, they would have to pay a premium, which is market-driven.

Moreover, a brokerage fee is due. It is usually not considered risky if formed on covering short-term demands. However, if the hedging party places an incorrect bet, then they may miss out on potential savings.

For example , if a copper manufacturer has a capacity of 200 tons and decides to sell 300 tons on the futures exchange the remaining 100 tons is considered as speculation in the market. If prices fall then he stands to benefit, however if prices go up the 200 tons he produces can be delivered on the exchange but he would have to incur losses on the additional 100 tons.