Foreign Currency Derivatives

Chapter

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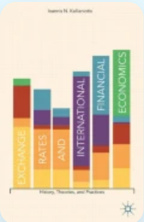

Exchange Rates and International Financial Economics

John N. Kallianiotis

Abstract

A *foreign currency derivative* is a financial derivative whose payoff depends on the foreign exchange rates of two (or more) currencies. These instruments are commonly used for hedging foreign exchange risk or for currency speculation and arbitrage. Specific foreign exchange derivatives include: *foreign currency forward contracts*, *foreign currency futures*, *foreign currency swaps*, *currency options*, and *foreign exchange binary options*. These instruments are called derivatives because their value is derived from an underlying asset, a foreign currency. The financial managers of MNCs purchase these financial derivatives in order to reduce the risk associated with cash flows denominated in foreign currency, hedging this exchange rate risk or to take positions in the expectation of profit, speculation, or arbitrage. Financial derivatives are powerful tools of hedging (redistributing) foreign exchange risk, but at the same time, they are very risky instruments for

inexperienced financial managers. Lately, there were many cases in which financial managers generated enormous losses for their companies (mostly banks) and led them to bankruptcy. Of course, the rule is always moderation and prudence. If we want to go one step further, the rule is the maximization of the social welfare of a nation.

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