What are currency derivatives?

Currency derivative is a contract between two traders agreeing to exchange currency at a fixed price at a future date.

Currency derivatives, in simple words, are contracts between the buyer and the seller trading in currencies. According to this contract, both the parties decide to exchange one currency for another on a future date at a price that is set at the beginning of the contract.

One of the main reasons why people enter in such an agreement is hedging. Hedging is a risk management tool or insurance against any unwanted movements in the currency rates in future. Through currency derivatives, traders protect themselves from any upside or downside risk.

Let us consider an example to understand the concept better. Say a company (ABC Ltd) in the UK, doing business with another company (XYZ Ltd) in the US, usually receives payment a month after the delivery date. In case of an unstable economic condition in the UK, there is a risk of currency value depreciation in the future, which might result in a loss for ABC Ltd.

In such a scenario, ABC Ltd will enter into a currency derivative contract today to ensure that it gets a fixed rate of exchange in the future.

Investors trade in currency derivatives mainly due to the following advantages:

Fixed lot size

The lot size, that is, the number of currency units per lot is determined by the regulating exchange. One of the main advantages of currency derivatives is that traders, when participating in such contracts, can trade multiple lots per contract.

Highly liquid

The foreign exchange market is considered to be the most liquid market in the world. This means that traders can enter or exit the market at any moment, in any given market condition, due to the availability of multiple buyers and traders.

No manipulation

Given the size of the market and the number of players involved, it is impossible for a single entity or an individual to manipulate the market. Even central banks with their high volume of transactions cannot push the market in the desired direction.