1 Introduction

Since the breakdown of the Bretton Woods agreement in the early 1970s, currencies of the major industrial nations have fluctuated widely in response to trade imbalances, interest rates, commodity prices, war and political uncertainty. In recent years, the pressure of governments maintaining currency parity has led to the breakdown of quite a few exchange rate mechanisms and has, thus, reinforced the need for companies, in particular, to take active foreign exchange hedging decisions in order to prevent the erosion of profit margins.

1.1 THE FORWARD FOREIGN EXCHANGE MARKET

The forward foreign exchange market developed to assist companies protect themselves from some of the uncertainty of exchange rate movements, but foreign exchange forwards are truly appropriate for known exposures. Using them to cover contingent, variable or translation exposures could force a company to accept losses on unnecessary currency transactions. Not only that, but rival companies that leave their exposure unhedged may suddenly acquire a competitive advantage. This has, therefore, partially led to the expansion in the currency options market, which has been even more spectacular than the tremendous growth seen in the entire foreign exchange market over the past decade or so.

1.2 THE CURRENCY OPTIONS MARKET

The currency options market shares its origins with the new markets in derivative products and was developed to cope with the rise in volatility in the financial markets worldwide. In the foreign exchange markets, the dramatic rise (1983 to 1985) and the subsequent fall (1985 to 1987) in the dollar caused major problems for central banks, corporate treasurers, and international investors alike. Windfall foreign exchange losses became enormous for the treasurer who failed to hedge, or who hedged too soon, or who borrowed money in the wrong currency. The investor in the international bond market soon discovered that the risk on their bond position could appear insignificant relative to their currency exposure. Therefore, currency options were developed, not as another interesting off-balance sheet trading vehicle but as an alternative risk management tool to the spot and forward foreign exchange markets. Therefore, they are a product of currency market volatility and owe their existence to the demands of foreign exchange users for alternative hedging and exposure management techniques.

Today, the currency options market is traded in its listed form mainly in Philadelphia and Chicago. There is also a liquid interbank market or over-the-counter market (OTC), which exists in all the world's financial centres. The importance of options is that they have bought an extra dimension, i.e. volatility, to the financial markets. By using options, it is possible to take a view not only on the direction of a price change, but also on the volatility of that price.

1.3 THE ALTERNATIVES TO CURRENCY OPTIONS

Considering over-the-counter currency options versus foreign exchange forwards:

Currency options	Foreign exchange forwards
Right but not an obligation to buy/sell a currency	Obligation to buy/sell a currency
Premium payable	No premium payable
Wide range of strike prices	Only one forward rate for a particular date
Retains unlimited profit potential while limiting downside risk	Eliminates the upside potential as well as the downside risk
Flexible delivery date of currency (can buy an option longer than needed)	Fixed delivery date of currency

And considering over-the-counter currency options versus open positions:

Currency options	Foreign exchange positions
Right but not an obligation to buy/sell a currency	No obligation to buy/sell a currency
Premium payable	No premium payable
Retains unlimited profit potential while limiting downside risk	Profit and loss potential unlimited
Flexible delivery date of currency	Indefinite delivery date of currency

1.4 THE USERS

The users of the market are widespread and varied, from commercial and investment banks which take strategic currency positions or which may offset some of their over-the-counter options exposure in the listed market, to corporate treasurers and international investment managers wishing to hedge their currency risk or to increase their returns on overseas assets, to private individuals looking to hedge an offshore exposure such as the purchase or sale of a house, to those wishing to speculate in the foreign exchange market.

1.5 WHOSE DOMAIN?

As with the foreign exchange market, activity in the currency options market remains predominately the domain of the large professional players, for example major international banks, but with liquidity and the availability of margin trading, this 24-hour market is accessible to any person with the relevant knowledge. However, a very disciplined approach to trading must be followed, as both profit opportunities and potential loss are equal and opposite.