Traders in Tennis Shoes:
Derivatives, Volatility, Risk and Supervisory Issues

Recent turmoil in international financial markets, including the collapse of Barings Bank, the Mexican economic crisis and the fall of the U.S. dollar against both the deutschemark and the yen, has drawn much attention. The news media and other observers have portrayed these events as symptomatic of an increasingly fragile world financial order. The system appears unable to respond to shocks, and seems increasingly subject to speculation and the influence of financial derivative instruments that are not easily understood. As a result, there have been suggestions from the public and private sectors that the G-7 leaders "do something" at the upcoming summit in Halifax to enhance financial market stability. This Commentary will provide some context for those suggestions by examining derivatives markets, and where G-7 energies might best be directed to deal with the risks that financial instability and derivatives pose for markets and participant firms.[1]

There are two related themes that are woven into most suggested reforms of financial markets. First, there is concern about excess volatility in financial markets, and particularly in foreign exchange markets. Second, the markets' capacity for large and instantaneous flows of capital ties them together to such a degree that there is concern about the possibility of either an institutional collapse (such as Barings Bank) or difficulties in a specific market (such as Mexico) spreading rapidly and uncontrollably around the world. The risk that troubles in a market or firm cannot be contained, and adversely affect other markets or firms, is known as systemic risk. Before considering the merits of these concerns, it is helpful to explain briefly the concept of derivative financial instruments, their uses and the markets in which they trade.

Derivatives: What Are They and Where Are They Traded?

A derivative is a financial instrument whose value is linked to or derived from the price of an underlying security or commodity. Among the most common and easily understood derivatives are futures and options. A futures contract specifies the purchase or sale conditions of an asset at some future date. An options contract is

[1] For an earlier Commentary on exchange rate volatility, see J. McCormack, *Not Out of the (Bretton) Woods Yet: Exchange Rate Disequilibria, Trade and Suggested Reforms*, Policy Staff Commentary No. 6, February 1995.