



Explicit versus Implicit Contracts: The Case of DIFF and CROSS Futures

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Abstract

This paper investigates the potential success of an explicit futures contract when an implicit one, which can duplicate it, exists. It is hypothesized that the success of the explicit futures contract depends on its value added being greater than that of its implicit counterpart given that sufficient hedging demand exists for it. Following a discussion of value added analysis, hedging effectiveness of the Euro-rate Differential (DIFF), the Currency Cross-rate (CROSS) futures contracts, and their implicit counterparts are calculated and tests of relative hedging effectiveness of these contracts are performed. Test results support the hypothesis of the paper and their implications for new futures contract development are discussed.

Keywords: hedging effectiveness, explicit contracts, implicit contracts, synthetic futures contracts, value-added analysis

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1. Introduction

Over the years, success and failure of futures contracts have attracted the interest of both academicians and practitioners. Success of a new contract has substantial implications for the prosperity of the exchange that introduces it, for the

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