A forward contract is an agreement to exchange assets in the future at a predetermined price. It plays a vital role in the Western financial markets and serves as the basic building block for more advanced and sophisticated financial instruments. The primary function of the forward market is to provide a vehicle to hedge against unexpected and undesirable price fluctuations. The forward market directly affects the spot market as it also offers arbitrage and speculation opportunities. Forward markets also serve the purpose of “price discovery”—the process of determining the equilibrium prices that reflect current and positive demands for current and prospective supplies, and making these prices visible to all.1

The forward contracts in commodities are the simplest type of derivatives. In such a contract the parties could be a producer who promises to supply the product and a consumer who needs the product. Forward contracts are common in merchandise or commodities trading. Without them, business trade and planning would be greatly hindered. If a small baking company could not order flour in advance for its immediate needs, for example, it would have to buy a large quantity at a prevailing price and store it for future use. There would be uncertainty about what the price would be when the next order is placed. The miller will have a more difficult task in planning how much flour to produce without orders in hand, and shortages would be more likely to occur.2

To see how a typical forward contract works, let us examine a simple example of a cocoa farmer (producer) and a confectioner who needs cocoa for his product (consumer). To simplify matters, let us say the farmer has planted cocoa and expects to harvest 120 tons of cocoa in six months. The confectioner, on the other hand, has cocoa in his

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the forward commodities market

The forward commodities market

inventory to last him for the next six months but will need to replenish his inventory in six months with 120 tons. Though simplified, this is a very common business situation. We have a producer who will have product available at a future date and a consumer who will need the product in the future. Clearly, both parties face risk, essentially price risk. While the farmer will be fearful of a fall in the spot price of cocoa between now and six months from now, the confectioner will be susceptible to an increase in the spot price. Thus, both parties face risk, but in the opposite direction. It would be logical for both parties to meet, negotiate, and agree on a price at which the transaction can be carried out in six months. Once the terms are formalized and documented, we have a forward contract accruing to both parties. Both parties, because of the forward contract, have eliminated all price risk. The farmer now knows the price he will receive for his cocoa regardless of what happens to cocoa prices over the six months. The confectioner too has eliminated price risk since he will only have to pay the agreed upon price, regardless of spot prices in the next six months. There is a second benefit to this. Since both parties have “locked-in” their price/cost, they would be in a much better position to plan their business activities. For example, the confectioner can confidently quote to his customers the price at which he delivers them products in the future. This would not have been possible if he were uncertain about his input price. The benefits of a forward contract, therefore, are often more than merely hedging price risk.³

Economic Benefits of the Forward Contract

Some shari‘ah scholars have argued in favor of this contract. ʿAbd al-Wahāb Abū Sulaimān, for instance, said “The need for this contract is not a need confined to a specific nation, it is a need for all nations around the globe whatever their status of civilization, developed or developing. The principle in Islamic law is that the general need could be considered as necessity (al-hājah idhā ʿammat kānat ka al-ḍarūrah).”⁴

³ See Obiyathulla Ismath Bacha, “Derivative Instruments and Islamic Finance: Some Thoughts for a Reconsideration,” p. 3.
⁴ ʿAbd al-Wahhāb Abū Sulaimān ʿAqd al-Tawrīd Dirāsh Fiqhiyyah Tahliliyyah” paper presented to the twelfth session of the Islamic Fiqh Academy, Rabat, Morocco, p. 7.