“Exchange Rate Risk.”
A future payment (liability) or receipt (asset) denominated in a foreign currency

The forward market is used to hedge future asset or liability positions in the F.E. market.

**How to Hedge in the FE market**
Three exchange rates are involved:
- $r_s$ - the spot rate
- $r_f$ - the forward rate
- $r_{se}$ - the expected spot rate

**Hedging future liability position**
– Must *pay £1m in 90 days*.

- Make a forward contract to buy £1m.
- In 90 days, buy £1m at forward rate

Avoid risk (that spot rate rises)

**Hedging future asset position**
– Will *receive £1m in 90 days*.

- Make a forward contract to sell £1m.
- In 90 days, sell £1m at forward rate.

Avoid risk (that spot rate falls)