Journal of Business and Policy Research
Vol. 11. No. 1. July 2016. Pp. 1 – 15

Indirect Currency Futures Hedging

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We examine the problem of hedging a foreign exchange exposure using a futures contract on the value of the local currency in terms of the foreign currency. This process will be referred to as indirect currency futures hedging. A general formula for the minimum-variance indirect currency futures hedge ratio is derived and special cases of this formula are obtained for commonly made assumptions about the joint spot and futures price process. The performance of the indirect hedge is found not to depend heavily on specific assumptions about the joint spot and futures price process. Furthermore, it is confirmed that the indirect currency futures hedge is as effective at reducing foreign exchange risk as a corresponding direct hedge.

JEL Codes: F31, G19