Forward Exchange Rate

Based on Chap 17 of Pugel and Lindert

(The sun is really setting since this is the last topic)

Topics

- Hedging is the act of reducing risk of an asset, say foreign exchange holding.
- Speculating is the act of taking a net asset position ("long") or a a net liability position ("short") in some asset class, here a foreign exchange.
- A forward exchange contract is an agreement to exchange one currency for another on some date in future at a price set now (the *forward exchange rate*). Common dates for future exchange are 30, 90, 180. Example, say 90 day forward exchange rate for Sterling at $1.6340.

Topics (continued)

- covered international investment
  - when the exchange rate at which anticipated foreign investment returns will be redeemed is determined in the present through a forward contract.
- uncovered international investment
  - when the exchange rate at which anticipated investment returns will be redeemed is not determined until the trade occurs at the future spot rate.
- covered interest differential
  - the difference between the rate of returns from investing money in the US at the market rate of interest or participating in the spot and forward markets for U.S. dollars and another currency.
- forward premium
  - the proportionate difference between the current forward exchange rate value of a currency and its current spot value.

Topics (continued)

- Long position
  - A net asset position
- Short position
  - A net liability position
- Covered interest arbitrage
  - Buying a country's currency spot and selling it forward, while making a profit off the combination of higher interest rates in that country and any forward premium on its currency.
- Covered interest parity
  - The condition where the forward rate of a currency is more than the spot rate by the same percentage that its interest rate is lower than the other country's interest rate.

Topics (Contd..)

- Uncovered interest parity
  - When a currency is expected to appreciate by as much as its interest rate is lower than the interest rate in the other country.
- Capital controls
  - Government policies that limit the ability of financial investors to transfer moneys in or out of the country.
- Currency swap
  - An agreement to sell a currency today with the provision that the currency will be resold later.
- George Soros
  - An international investment guru.