Cross-hedging foreign currency risk: Empirical evidence from an error correction model

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Abstract

In this article, the traditional price change hedge ratio estimation method is extended by applying the theory of cointegration in the case of cross-hedging of spot exchange risk of the Belgian franc (BF), the Italian lira (IL), and the Dutch guilder (NG) with U.S. Dollar Index futures contracts. Previous studies ignore the last period's equilibrium error and short-run deviations. The findings of this study indicate that the hedge ratio estimated by the error correction method is superior to that obtained from the traditional method, as evidenced by the likelihood ratio test and out-of-sample forecasts. Hedgers will be able to control the risk of their portfolios more effectively at a lower cost.

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