11.9: Spot vs. Forward Rates

The **Spot Rate** refers to the exchange rate for a transaction to take place today. Alternatively, the **Forward Rate** refers to an exchange rate that is set today, but the transaction does not take place until a later date. The spot and forward rates will rarely be equal and the difference is typically based on interest rate differentials between the two countries. Forward rates (and associated forward contracts) provide a way for firms to reduce (hedge) their exchange rate risk by locking in an exchange rate. Consider a US firm that agrees to sell 10,000 widgets to a German firm for 125,000 euros on credit with the payment being due in 2 months. The US firm is now subject to exchange rate risk (if the dollar strengthens, the euros will be worth less at the time they are received). By entering into a forward contract that allows them to exchange euros for dollars at the agreed forward rate, they no longer have this exchange rate risk as they now know exactly how much the 125,000 in euros will be worth when payment is received in 2 months.