



# **Microeconomic Risk Management and Macroeconomic Stability: 625 (Lecture Notes in Economics and Mathematical Systems)**

*Andreas Röthig*

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“The essence of a hedging contract is a coincident purchase and sale in two markets which are expected to behave in such a way that any loss realized in one will be offset by an equivalent gain in the other. If such behavior follows a perfect hedge has been effected.” Hardy and Lyon (1923, p. 276). 1. 1

LiteratureReviewandMotivation In the traditional hedging literature, the two markets in which hedgers trade are spot and futures markets. The trader’s position in the spot market is generally considered as given.

According to Johnson (1960), hedging can be meaningfully defined only if the spot market is regarded as the trader’s primary market. The futures market is used solely to counterbalance an existing position in the spot market. Speculators, in contrast, do not have a commitment in the spot market. They take on risk in futures markets in order to profit from expected price changes. The hedger synchronizes his trading activities in spot and futures markets in order to reduce spot risk. In the literature this approach to hedging is labeled risk reduction concept. Risk reduction will be achieved if spot and futures prices move more or less in parallel. If prices are perfectly correlated, risk is abolished, since losses in one market are perfectly offset by profits in the other market. However, as Hardy and Lyon (1923) point out, any divergence from perfect correlation results in an imperfect hedge.

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