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ORIGINAL ARTICLE

The impact of inflation risk on forward trading and production

Udo Broll[1] · **Kit Pong Wong**[2]

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Abstract This paper examines the behavior of a competitive firm that faces joint price and inflation risk. Given that the price risk is negatively correlated with the inflation risk in the sense of expectation dependence, we show that the firm optimally opts for an over-hedge (under-hedge) if the firm's coefficient of relative risk aversion is everywhere no greater (no smaller) than unity. We show further that banning the firm from forward trading may induce the firm to produce more or less, depending on whether the price risk premium is positive or negative, respectively. While the price risk premium is unambiguously negative in the absence of the inflation risk, it is not the case when the inflation risk prevails. In contrast to the conventional wisdom, forward hedging needs not always promote production should firms take inflation seriously.

Keywords Forward hedging · Expectation dependence · Inflation risk · Production

JEL Classification D21 · D24 · D81

Udo Broll
udo.broll@tu-dresden.de

1 Department of Business and Economics, School of International Studies (ZIS), Technische Universität Dresden, Helmholzstr. 10, 01062 Dresden, Germany

2 University of Hong Kong, Hong Kong, China