

Report Type

End of Award Report

Full Name

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Faculty/Department

JBS

Project Title

- Currency regimes, market microstructure and the currency risk premium

Project Start Date

Apr 30, 2016

Project End Date

Jul 31, 2017

Project Abstract

The project focuses on the relationship between exchange rate regime and carry trade returns over the very long-run. We have constructed a new data set of daily bid and ask quotes for both spot and forward exchange rates on the London market from 1919 to the present. In addition, we motivate our empirical analysis by extending the Lustig, Roussanov, and Verdelhan (2014) model such that it allows risk compensation in foreign exchange markets to depend on currency regimes. Specifically, the pricing kernels of countries in the fixed regime are characterised by symmetric exposures to a global risk factor and as such we show that carry returns based on fixed currency pairs should be near-zero. Conversely, the pricing kernels of countries in the floating regime are asymmetrically exposed to the global risk factor such that currencies with high interest rates command a larger risk premium. Consistent with our model, the empirical analysis demonstrates that the outsized unconditional return to the carry trade is almost exclusively driven by the floating currency pairs in our sample. Furthermore, our model also allows regime shocks to affect carry returns. Empirically we find that the collapse of a currency peg on average spills over into floating currency pairs resulting in negative shocks to carry trade returns. Such currency regime shifts may offer an explanation for the positive mean return to the carry trade over the long-run.

Activities and Achievement

The main result to date is to document the long run performance of the carry trade using a new foreign exchange dataset covering the entire history of established trading in the foreign exchange markets from 1919 to the present. Using this database we confirm that the carry trade generates robustly significant long run performance. This evidence is invariant across different weighting schemes for the carry trade strategy and after transaction costs are deducted. Our key contribution is to take a novel approach to examining how the risk and return of the carry trade are related to currency regimes over this long run sample period. We report two main findings. First, we find large carry trade return variations that are related to the time-series and cross-section of exchange rate regimes. The superior carry trade performance is attributable exclusively to exchange rates in the floating regime. Exchange rates in the fixed regime tend to change in a way that is consistent with the uncovered interest parity (UIP). Second, exchange rate regime shifts offer a potential channel to explain the positive mean return to the carry trade as evidenced by the fixed-to-floating switch being correlated with negative shocks to carry trade returns.

Dissemination

The intention is to submit the first paper to a top 3 finance journal. We also have good ideas for a second paper.

The paper has been accepted at a number of conferences including the 2018 AEA meetings.

Outputs

Title: Currency Regimes and the Carry Trade

Abstract: This paper exploits the time-series and cross-sectional variation in exchange rate regimes,

between fixed and floating, over the last century and studies the relationship between exchange rate regime and carry trade returns. In order to motivate our empirical analysis

we extend the Lustig, Roussanov, and Verdelhan (2014) model such that it allows risk compensation in foreign exchange markets to depend on currency regimes.

Specifically,

the pricing kernels of countries in the fixed regime are characterised by symmetric exposures to a global risk factor and as such we show that carry returns based on fixed currency pairs should be near-zero. Conversely, the pricing kernels of countries in the floating regime are asymmetrically exposed to the global risk factor such that currencies with high interest rates command a larger risk premium. Consistent with our

model, the empirical analysis demonstrates that the outsized unconditional return to the carry trade is almost exclusively driven by the floating currency pairs in our sample.

Furthermore, our model also allows regime shocks to affect carry returns. Empirically we

find that the collapse of a currency peg on average spills over into floating currency pairs

resulting in negative shocks to carry trade returns. Such currency regime shifts may offer

an explanation for the positive mean return to the carry trade over the long-run.

c) The paper will be uploaded shortly to ssrn.

d) none yet

e) Conferences (including those accepted): Infiniti (Dublin) 2017, World Congress of Cliometrics 2017, European Economics Association Meeting 2017, AEA (Philadelphia) 2018

Seminars: Bank of England, Cambridge Finance, Cass Business School, and Warwick Business School

Major Difficulties and Any Other Issues

None

Web Links

None yet. The paper will be uploaded to ssrn in early September