Report Type
> Mid Term Award Report

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Project Title
> Currency regimes, market microstructure and the currency risk premium

Project Start Date
> Jul 01, 2015

Project End Date
> Jun 30, 2017

Project Abstract
> We pursue following two research themes:
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> First, we study the currency risk premium over the long-run and the impact of regime changes on the returns to currency speculation. The asset pricing literature has centered on understanding expected return or risk premium. However, the existing literature is lacking a long-run perspective on currency risk and return and on the impact of monetary regime changes. Existing research on currencies typically focuses on the post-Bretton Woods floating period from 1983. Examining the impact of monetary regime shifts on currency returns therefore offers academics and practitioners a new perspective on the risk-return tradeoff in currency speculation.
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> Second, we study the determinants of bid-ask spreads in the foreign exchange markets. The market microstructure literature argues that bid-ask spread arises due to dealing costs, inventory costs, and adverse selection. However, the literature has struggled to come up with an empirical strategy to identify the three determinants of the bid-ask spread as the measurement requires some inputs that are either non-observable or difficult to quantify. We adopt a novel alternative approach to the estimation of the three components of bid-ask spread in the foreign exchange market, exploiting the implications of exchange rate regimes. For example, in a (credible) fixed regime, bid-ask spreads are solely driven by dealing costs as market makers do not face inventory risk or information asymmetry.

Activities and Achievement
> 1. We presented our preliminary results during CERF Monday Lunch in November, 2016.
> 2. We completed a first draft of the paper on currency regimes and the carry trade near the end of January, 2017. In this preliminary version of the paper, we documented three empirical findings: (i) The carry trade strategy earns significant average returns over the long run (1919-2016) as well and the performance is robust to differing portfolio weights and remains significant both economically and statistically after transaction costs; (ii) the performance of the carry trade varies with the time-series and cross-section of exchange rate regimes; (iii) the collapse of currency pegs has spill-over effects on floating currency pairs, thereby causing significant losses to carry traders.
> 3. We revised our paper based on feedbacks received during the presentation of our paper at Cass Business School. For example, we provided a number of robustness

checks to verify our results on the regime-dependence of carry trade returns.

4. We made further revisions of our paper based on other comments including those received during the presentation of our paper at Warwick Business School. Most importantly, we provided a theoretical framework to better motivate our empirical analysis and to interpret our empirical results.

5. We have submitted our paper to a number of international conference, including AEA, EEA, NFA, CICF, Infiniti, Cliometrics, etc. Our paper has been accepted into the programs of Cliometrics, Infiniti and CICF so far.

6. We are revising the paper further to address the link between the theory and the empirical results. We will present the latest version of our paper at the Bank of England in April, 2017.

Dissemination

None.

Outputs

Major Difficulties and Any Other Issues

None

Web Links

None

Additional Information

Declaration

This award has not yet produced any relevant outputs, but details of any future publications will be submitted to the CERF database as soon as they become available.

Signature - Main Award Holder