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COVERED INTEREST ARBITRAGE AND MARKET TURBULENCE*

Mark P. Taylor

Much of international monetary economics can be viewed as resting upon various international parity relationships – uncovered interest parity, short- or long-run purchasing power parity, covered interest parity. The purpose of the present paper is a detailed empirical examination of one of these relationships, covered interest parity, using high-frequency, high-quality data covering various historical periods in which there is known to have been turbulence in the international foreign-exchange and capital markets.

The covered interest parity theorem states that the interest differential between two assets, identical in every respect except currency of denomination, should be zero once allowance is made for cover in the forward exchange market. Profitable deviations of the covered interest differential from zero represent riskless arbitrage opportunities and may therefore indicate market inefficiency. Empirical investigations of covered interest parity thus form part of an ongoing research programme on the efficiency of the foreign exchange and international capital markets (see e.g. Levich, 1979, 1985; MacDonald and Taylor, 1989*a* for surveys). If an efficient market is defined as one in which current prices reflect all available information, then it follows that agents in such a market cannot earn abnormal profits by exploiting current information. The economic importance of efficient capital markets derives from the fact that they should help to ensure an optimal allocation of resources (Fama, 1970, 1976).

Apart from intrinsic interest in the covered interest parity condition and its implications for market efficiency, it is also of interest in that it is often used much as an identity in testing other implications of the efficient markets hypothesis. For example, given *covered* interest parity, then testing *uncovered* interest parity reduces to testing the forward rate as a spot rate predictor (see e.g. Boothe and Longworth, 1986 or MacDonald and Taylor, 1989*a* for a discussion of such tests). Similarly, covered interest parity can be seen as linking the term structure of interest rates to the term structure of forward exchange premia (see e.g. Hakkio, 1981; MacDonald and Taylor, 1989*b*).

Another motivation for examining international parity conditions arises from their use in the construction of theoretical and empirical models of

* Any views expressed in this paper are those of the author and are not necessarily those of the Bank of England. The paper has been substantially revised in the light of the comments of the editor and three anonymous referees, as well as those of Michael Costello, Chief Dealer of the Bank of England, and the Treasury Director of the Royal Trust Bank, London, Charles Baxter. I am particularly grateful to Charles Baxter for a number of illuminating discussions on this topic. I am also grateful to Paresh Kanani for able research assistance. The usual disclaimer applies in all cases. A previous version of this paper appeared as CEPR Discussion Paper No. 236.

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