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Mark P. Taylor

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COVERED INTEREST ARBITRAGE AND MARKET TURBULENCE*

Mark P. Taylor

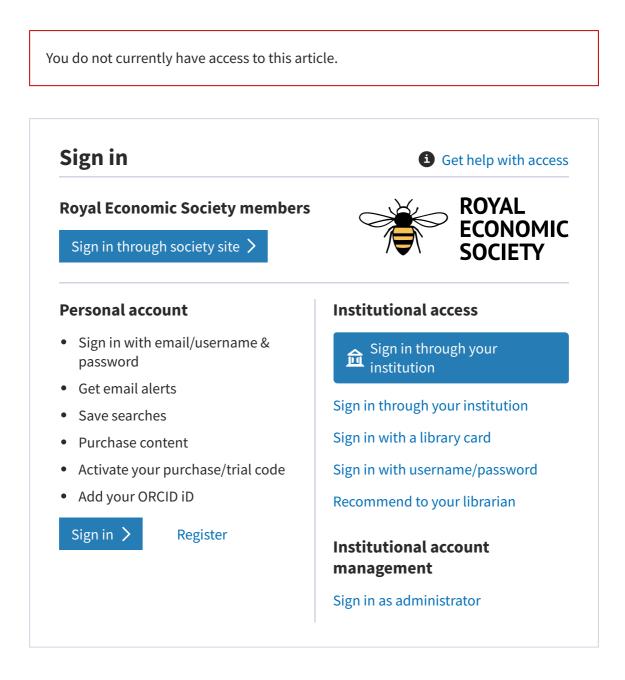
Much of international monetary economics can be viewed as resting upon various international parity relationships – uncovered interest parity, short- or long-run purchasing power parity, covered interest parity. The purpose of the present paper is a detailed empirical examination of one of these relationships, 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

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