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NAFTA's Financial Convergence: Measurement by Dynamic Moment Analysis of Daily FX Forward Term Premiums

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Abstract

In the context of both the reluctance of China to make its Yuan flexible and the current havoc of the sovereign debt markets in Europe, the philosophical debate about the pros and cons of fixed versus flexible exchange rates leaves out an important superior alternative system: flexible spot exchange rates cum efficient forward exchange rates. This combined system allows individuals and companies, instead of governments, to fix forward their own exchange rates for limited and finite fixed horizons (terms), while maintaining an overall flexible exchange rate market. Such a system has been in existence in North America since the NAFTA. Applying market arbitrage theory on daily data, we measure the statistical convergence of NAFTA's financial markets since 1994. Radar diagram and wavelet multi-resolution analysis (MRA) scalogram movies of the statistical moments of the term interest rate differentials visualize the multidimensional convergence. From the radar movies, we find: 1) a uniform disappearance of the average forward premia; 2) a non-uniform decline of bilateral financial market risk; 3) variation of bilateral financial market pressure measured by skewness; and 4) emergence of uniform market microstructures as measured by vanishing excess-kurtosis. From our MRA movies, we find that the national term structures of interest rates converge, since the stochastic resonance coefficients of the interest rate differentials lose significance: market energy at all frequencies dissipates into "white noise." We also find that, after 2002, higher financial flow pressure was a necessary condition for lower financial market risk.

Keywords: Convergence, Foreign Exchange, Forward Premiums, Term Structures, Dynamic Moment Analysis, Wavelet Multiresolution Analysis, Flexible Exchange Rates, Fixed Exchange Rates

JEL Classification: C22, E43, F31, F36, G15, N20

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