



Transactions Costs and Covered Interest Arbitrage: Theory and Evidence

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Abstract

The extent to which deviations from covered interest parity can be attributed to transactions costs has been exaggerated in the economic literature because the swap market in foreign exchange has been ignored. It is shown that such deviations should be no greater than the lowest of the transactions costs in one of three markets: the swap market or either of the two relevant securities markets. This reconciles the theory with the data, which show spreads of no more than a few basis points. However, the empirical results have no direct bearing on the conventional market efficiency hypothesis.

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