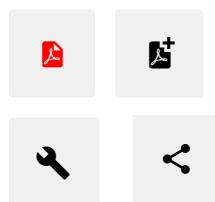


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## Covered Interest Arbitrage: Unexploited Profits? Comment

Frank McCormick

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### Confirmations and Contradictions

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## Covered Interest Arbitrage: Unexploited Profits? Comment

Frank McCormick

*Division of International Finance,  
Board of Governors of the Federal Reserve System*

In two recent articles in this *Journal* (April 1975 and December 1977), Frenkel and LeVich (henceforth F-L) undertook the very difficult task of trying to show that most discrepancies from covered interest arbitrage parity can be explained by transaction costs in the securities and foreign-exchange markets.

In this comment, I will argue that F-L's data—although perhaps the best published data available—are subject to some limitations. I will also argue that F-L's data do not illustrate the lack of arbitrage opportunities.

adopt F-L's methodology and will apply it to data of a higher quality. The resulting estimates of the transaction costs in the foreign-exchange market are considerably lower than the estimates provided by F-L. These new estimates cast doubt on F-L's conclusion that most discrepancies from covered interest arbitrage parity for U.S. and U.K. Treasury bills for the 1962-67 and 1973-75 periods can be explained by transaction costs.

## **I. F-L's Method of Estimating Transaction Costs in the Foreign-Exchange Market**

The following explains F-L's method of estimating foreign-exchange-market transaction costs: A holder of dollars who desires to

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