

# Covered Interest Arbitrage: Unexploited Profits? Comment

Frank McCormick

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## Confirmations and Contradictions

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*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

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

The views expressed herein are solely those of the author and do not necessarily represent the views of the Federal Reserve System. The author would like to express his thanks to several economists in the Division of International Finance for helpful comments, particularly Ralph Smith, and to Katie Meskill and Cynthia Hart for valuable research assistance. None are responsible for any errors that remain.

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