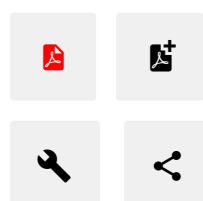


[← PREVIOUS ARTICLE](#)[NEXT ARTICLE >](#)[CONFIRMATIONS AND CONTRADICTIONS](#)

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Confirmations and Contradictions

Covered Interest Arbitrage: Unexploited Profits? Comment

Frank McCormick

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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

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