Bond spreads, exchange rate movements and risks

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This paper looks at the uncovered interest parity condition and the forward premium puzzle from a bond market perspective. Interest parity is rewritten as a bond pricing equation, with domestic interest rates being determined by foreign interest rates, exchange rate risk, and further risk factors, like default risk.

This enables a detailed look into the working and the failure of interest parity: whether it is due to the transmission coefficient, the exchange rate risk coefficient or extra risk terms. Moreover, this flexible framework also establishes a practical link between domestic interest rates and exchange rate movements, giving policymakers some guideline about the influence of interest rate decisions on exchange rate behavior.

Using quarterly interest and exchange rate data, I find evidence for a too low transmission coefficient and a role for extra risks; but the coefficient of the exchange rate risk has the right sign and order of magnitude: it is almost one for developing countries, and around 0.25 for developed economies.