



Apr 23rd, 9:00 AM - 4:00 PM

# An Empirical Study of Covered Interest Arbitrage Margins During the European Monetary Crisis

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Saarinen, Ossi and Leekley, Faculty Advisor, Dr. Robert, "An Empirical Study of Covered Interest Arbitrage Margins During the European Monetary Crisis" (1994). *John Wesley Powell Student Research Conference*. 52.  
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AN EMPIRICAL STUDY OF COVERED INTEREST  
ARBITRAGE MARGINS DURING THE EUROPEAN MONETARY CRISIS

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Interest parity in international financial markets exists when the interest rate differential between two countries is exactly offset by the forward exchange premium/discount. If at any moment the interest parity condition is not satisfied, traders can execute covered interest arbitrage. Covered interest arbitrage entails a series of four transactions in the currency and securities markets which results in a practically riskless profit. Although traditional economic theory predicts that the opportunities will be wiped out as individuals take advantage of the situation, covered interest arbitrage margins (CIAMs) have been observed to exist over extended periods of time.

Previous research in the area has attempted to rectify the discrepancy by identifying factors outside the basic arbitrage equation which work to negate profit opportunities. The most dominant of such factors in the literature have been transaction costs, partly because they are quantifiable. Other factors, such as political/financial center risk, timing problems, and imperfect elasticities of demand and supply have been explored as well, but are more difficult to pin down empirically.

My research attempts to show that transaction costs alone are not enough to explain away CIAMs. Rather, I wish to show that the political/financial center risk plays an important role in establishing effective interest parity. The focus is on the time period of summer 1992, when the European Monetary System crisis occurred, bringing along heavy speculation, volatility, and intervention in currency markets. A higher political/financial center risk for London is hypothesized to exist during this time period, producing margins that cannot be explained away by simple transaction costs. To achieve our goal, weekly calculations of CIAMs are computed along with proxies for transaction costs. To expose political/financial center risk, a traditional as well as a non-traditional pair of securities is used. It is hoped that data from the non-traditional pair coupled with transaction costs will explain a higher proportion of the observed CIAMs than the traditional pair/transaction costs combination, and thus reveal the importance of considering political/financial center risk in establishing market efficiency.