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Hyung-Seok Lim, Masao Ogaki

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# A THEORY OF EXCHANGE RATES AND THE TERM STRUCTURE OF INTEREST RATES

HYOUNG-SEOK LIM\*

MASAO OGAKI†

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THE OHIO STATE UNIVERSITY

DEPARTMENT OF ECONOMICS

## ABSTRACT

The purpose of this paper is to construct a model of exchange rate determination that is consistent with the stylized facts regarding the uncovered interest parity for short-term and long-term interest rates. This task is especially challenging because of the forward premium anomaly found for short-term interest rates and forward exchange rates. With an assumption that investors have a short investment horizon, the model is consistent with these stylized facts even when the degree of risk aversion is low. The model predicts a complicated relationship between exchange rates and the term structure of interest rates.

*Keywords:* forward premium anomaly, uncovered interest parity for long-term bonds  
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\* The Ohio State University, Department of Economics, Columbus OH 43210. Tel: (614) 292-2069, , Email: lim.148@osu.edu

† The Ohio State University, Department of Economics, Columbus OH 43210. Tel: (614) 292-5842, Fax: (614) 292-3906, E-mail: mogaki@econ.ohio-state.edu

# 1 Introduction

The purpose of this paper is to construct a model of exchange rate determination that is consistent with the stylized facts for short-term and long-term interest rates. This task is challenging because the forward premium anomaly is found for short-term interest rates but not for long-term interest rates.

For short-term interest rates and forward exchange rates, uncovered interest parity is typically rejected (see, e.g., Hodrick (1987) and Engel (1996) for recent surveys). As Engel (1996) emphasizes, one form of the rejection found in many recent papers is that the regression of future depreciation on the current forward premium (which is equal to the short-term interest rate differential under the covered interest parity) yields negative estimates of the slope coefficient. This is called the forward premium anomaly (also see Backus, Foresi, and Telmer (2001) for a recent discussion).

For long-term interest rates, more favorable evidence for uncovered interest parity has been found. Direct evidence is given by recent papers, such as Meredith and Chinn (1998) and Alexius (2001). They find that regressions of future depreciation over a long-horizon on the current long-term interest rate differential typically yield significantly positive estimates of the slope coefficient.<sup>1</sup> Indirect evidence has been found in the standard exchange rate models, such as Meese and Rogoff (1988), Edison and Pauls (1993) and Baxter (1994). Under the uncovered interest parity and the long-run purchasing power parity assumptions, they show that the long-term interest rate differential is more consistent with those assumptions than the short-term rate

<sup>1</sup>Alexius (1999) finds similar results for returns on long-term bonds over short investment horizons

differential. Similarly, implications of standard exchange rate models hold better in long-horizon data than in short-horizon data (see, e.g., Mark (1995)).

To the best of our knowledge, this paper is the first to build a model that is consistent with these stylized facts for both short-term and long-term interest rates.<sup>2</sup> It is difficult to find an economic explanation for the forward premium anomaly for short-term interest rates because neither the standard consumption-based asset pricing model with risk averse investors nor the dynamic term structure model can explain it (see, e.g., Mark and Wu (1998), Wu (2002)). Alvarez, Atkeson, and Kehoe (2002) construct a model of segmented asset markets which can be consistent with the forward premium anomaly. McCallum (1994) and Meredith and Chinn (1998) provide an explanation for the forward premium anomaly based on policy reactions. However, in their models, an unspecified error term is necessary for the uncovered interest parity relationship. The model in the present paper gives an alternative explanation that is not based on transactions costs nor on the assumption of an error term associated with the uncovered interest parity relationship.

In our partial equilibrium model of exchange rate determination for a small open economy, the domestic investors have a constant absolute risk aversion utility function over their wealth in the next period and the asset returns are normally distributed conditional on the available information. We assume that there are three assets in the model: a risk free asset called domestic short-term bonds and two risky assets: domestic long-term bonds and foreign bonds. Our intuition for constructing an economic model that is consistent with these stylized facts is based on effects of changes in risk premiums on foreign exchange rates. Given the conditional expectations and

<sup>2</sup>Our model is consistent with these stylized facts in the sense that we observe these patterns with high probability in small samples.

variances of all risky assets, we can decompose the effect of a change in the domestic short-term interest rate into two components. We define the direct risk premium effect to be the change in demand due to changes in the risk premium for foreign bonds when the risk premium for domestic long-term bonds is kept constant. We define the indirect risk premium effect to be the change in demand due to changes in the risk premium for domestic long-term bonds when the risk premium for foreign bonds is kept constant. The change in the demand for foreign bonds is the sum of these direct and indirect risk premium effects. In the special case of risk neutral investors, the indirect risk premium effect does not play any role. However, when investors are risk averse, it is necessary to evaluate both direct and indirect risk premium effects in order to study how the foreign exchange rate changes when the domestic short-term interest rate changes. In our model, the investors are also assumed to have a short investment horizon in our model. Given that many professional traders who actively trade in foreign exchange markets are likely to be assessed by their short-horizon performances by their employers, this assumption is justifiable.

The direct and indirect risk premium effects are properties of the demand for foreign bonds given the distributions of the asset returns and wealth conditional on the information available to the investors. In order to examine how these effects work in equilibrium, suppose that the domestic short-term interest rate rises. Then the risk premium for foreign bonds falls and the direct risk premium effect lowers the demand for foreign bonds without a change in the exchange rate. As the supply for foreign bonds is essentially fixed in the short-run by the cumulative current balance in the model, the domestic currency appreciates now, creating expected future depreciation of the currency in order to restore an equilibrium. If the domestic long-term interest

rate does not change, then the risk premium for domestic long-term bonds also falls as the domestic short-term interest rate rises. If the conditional covariance of the two risky assets returns is positive, the indirect risk premium effect increases the demand for foreign bonds. In this case, in order to restore an equilibrium, the domestic currency must depreciate this period, creating an expected appreciation in response to the indirect risk premium effect.

The sign and magnitude of the indirect risk premium effect depend on the conditional covariance. In the partial equilibrium model with given stochastic processes of interest rates, we endogenously derive the demand for foreign bonds by solving for the rational expectation equilibrium of the conditional expectation, variance, and covariance of the exchange rate. In equilibrium, the conditional covariance of the two risky assets returns is positive, and the direct and indirect risk premium effects have opposite signs. We show that under some reasonable parameter configurations, the indirect risk premium effect dominates the direct risk premium effect even when the degree of risk aversion is low. As a result, the domestic currency depreciates when the domestic short-term interest rate rises and the long-term interest rate does not rise. This feature of the model is the reason why the model is consistent with the forward premium anomaly for the short-term interest rate. On the other hand, when the domestic long-term interest rate rises with the domestic short-term interest rate, then the risk premium for domestic long-term bonds does not change, and the indirect risk premium effect does not affect the equilibrium exchange rate. Therefore, the domestic currency appreciates when the short-term and long-term interest rate rise

together. This feature of the model makes the model consistent with the stylized fact of the exchange rate and the long-term interest rate.<sup>3</sup>

In this paper, we show that the indirect risk premium effect is likely to be quantitatively important compared with the direct risk premium effect. In particular, we show that the indirect risk premium effect can even dominate the direct risk premium effect under reasonable parameter configurations. A Monte Carlo simulation for short-term regressions based on this parameter specification consistently shows the forward premium anomaly. The stronger the indirect risk premium effect, the more statistically significant the negative slope coefficient.

The result in this paper is in sharp contrast to the conventional view that short-term capital is more internationally mobile than long-term capital. The 1960's Operation Twist, in which the Federal Reserve and the Treasury attempted to raise the short-term rate relative to the long-term interest rate, was evidently based on this view. However, empirical work by Fukao and Okubo (1984) suggests that the relationship between the domestic long-term interest rate and the foreign interest rate is not limited to that which exists as a result of the relationship between the domestic short-term interest rate and the foreign interest rate. Popper (1993) presents empirical evidence that long-term capital is as internationally mobile as short-term capital.

The model in this paper has policy implications. It implies that the effectiveness of central bank attempts to affect exchange rates through the control of short-term interest rates depends on the responsiveness of long-term interest rates to changes in short-term interest rates.

<sup>3</sup>The intuition behind these results for direct and indirect risk premium effects can be generalized with Ogaki's (1990) concepts of direct and indirect substitution effects. This generalization is explained in an earlier version of the present paper, Ogaki (1999).

The rest of the paper is organized as follows. Section 2 presents the model. Section 3 derives the rational expectation equilibrium. First, given the covariance and variance assumed by agents, the rational expectation of the mean of the exchange rate is used to solve for the law of motion for the exchange rate. Then the condition for the rational expectation for the covariance is derived. Finally, the unique stable rational expectation equilibrium is found by equating the variance assumed by agents with the one implied by the demand function. Section 4 investigates the implications of the model on the relationship between the exchange rate and the term structure of interest rates. Conclusions are given in the last section.



## 2 The Model

As explained in the Introduction, the sign and magnitude of the indirect risk premium effect depend on the covariance conditional on the available information between the exchange rate and the short-term interest rate. At the same time, the demand for foreign bonds affects the dynamics of the exchange rate and covariance. Therefore, the demand for foreign bonds can be endogenously derived by solving for the rational expectation of the covariance, so that the covariance assumed by agents is consistent with the one implied by the demand function. It is technically difficult to solve for the rational expectation of the covariance in complicated asset pricing models. For this reason, this paper adopts a simple partial equilibrium exchange rate model, which is a three assets version of the models of Driskill and McCafferty (1980) and Fukao (1983) which use two assets (domestic and foreign short-term bond) and two countries. Those authors derive the demand function for foreign bonds endogenously by applying rational expectation to the variance of the exchange rate.

Consider a partial equilibrium model of exchange rate determination. For simplicity, the overall price level is assumed to be constant. Alternatively, all variables can be considered to be measured in real terms. Investors are assumed to live for two periods, and the same number of investors are born every period. There are 3 assets: domestic short-term bonds ( $=B_{S,t}$ ), domestic long-term bonds ( $=B_{L,t}$ ) and foreign bonds ( $=B_{F,t}$ ). As the foreign interest rate will be assumed to be constant, the foreign short and long-term bonds are perfect substitutes and do not need to be distinguished. The domestic short and long-term bonds are discount bonds paying one unit of the domestic currency after one period and two periods, respectively. The

foreign bonds behave in the same manner. At time  $t$ , a representative investor allocates his initial wealth ( $=W_t$ ) among 3 assets and he collects the payoffs paid by the assets he holds at the beginning of time  $t + 1$ .

Let  $q_t$  be the price of domestic long-term bonds at time  $t$  and  $r_t$  be the domestic short-term interest rate. Then the rate of return on holding domestic long-term bonds for one period,  $r_{L,t}$ , is

$$(2.1) \quad r_{L,t} = \frac{1}{q_t} \left( \frac{1}{1 + r_{t+1}} - q_t \right)$$

Since  $q_t = 1/(1 + R_t)^2$ , where  $R_t$  is the domestic long-term interest rate, it becomes

$$(2.2) \quad r_{L,t} = (1 + R_t)^2 \left( \frac{1}{1 + r_{t+1}} - \frac{1}{(1 + R_t)^2} \right) \approx 2R_t - r_{t+1}$$

Define the risk premium for domestic long-term bonds,  $\rho_{L,t}$ , to be the difference between the expected rate of return on holding long-term bonds for one period and that of short-term bonds;

$$(2.3) \quad \rho_{L,t} = E_t(r_{L,t}) - r_t = 2 \left[ R_t - \frac{1}{2} \{ r_t + E_t(r_{t+1}) \} \right]$$

where  $E_t$  is the expectation operator conditional on the information set in period  $t$ ,  $\Omega_t$ . We assume that  $\Omega_t$  includes the current and past values of  $r_t, R_t, r_t^*, R_t^*$ , and  $s_t$ , where  $r_t^*$ , and  $R_t^*$  are the foreign short and long-term interest rates, respectively, and  $s_t$  is the natural log of the exchange rate expressed in terms of the domestic currency.

The rate of return on holding foreign bonds for one period in terms of the domestic currency,  $r_{F,t}$ , is

$$(2.4) \quad r_{F,t} = r_t^* + s_{t+1} - s_t$$

Let  $\rho_{F,t}$ , the risk premium for foreign bonds, denote the difference between the expected rate of return on holding foreign bonds for one period and that of short-term

bonds;

$$(2.5) \quad \rho_{F,t} = E_t(r_{F,t}) - r_t = r_t^* + E_t(s_{t+1}) - s_t - r_t$$

The model assumes that, at time  $t$ , a representative investor with a constant absolute risk aversion (CARA) utility function maximizes his expected utility of wealth at the beginning of the time  $t + 1$  ( $=W_{t+1}$ ) subject to the budget constraint,

$$(2.6) \quad \begin{aligned} \max \quad & E_t\left(\frac{-e^{-kW_{t+1}}}{k}\right) \\ \text{s.t.} \quad & W_t = B_{S,t}^d + B_{L,t}^d + B_{F,t}^d \end{aligned}$$

where  $k$  is the coefficient of absolute risk aversion, and the superscript  $d$  denotes demand, so domestic currency amounts invested in domestic short, long-term, and foreign bonds are  $B_{S,t}^d$ ,  $B_{L,t}^d$ , and  $B_{F,t}^d$ , respectively.  $W_t$  is the initial wealth at time  $t$ , and the value of investor's assets at the beginning of time  $t + 1$ ,  $W_{t+1}$ , satisfies

$$(2.7) \quad W_{t+1} = B_{S,t}^d(1 + r_t) + B_{L,t}^d(1 + r_{L,t}) + B_{F,t}^d(1 + r_{F,t})$$

In the partial equilibrium model, the stochastic processes for the interest rates are exogenously given, and the utility function is parameterized. The equilibrium exchange rate satisfies the foreign bonds market clearing condition,  $B_{F,t}^d = B_{F,t}^s$ , where  $B_{F,t}^s$  is the supply of foreign bonds to the domestic residents. It is assumed to be equal to the cumulative current account balance and to follow the dynamic equation;

$$(2.8) \quad B_{F,t}^s = B_{F,t-1}^s + C_t,$$

where  $C_t$  is the current account balance in the period  $t$  satisfying<sup>4</sup>

$$(2.9) \quad C_t = -a + bs_t + u_t,$$

<sup>4</sup>Interest received by holders of foreign bonds is neglected

where  $b$  is a positive number, and  $u_t$  is the trade shock which is assumed to be white noise with variance  $\sigma_u^2$ .

Suppose that  $W_{t+1}$  is normally distributed conditional on  $\Omega_t$  and that the measure of the absolute risk aversion,  $k$ , is a positive constant. Under these assumptions, a representative investor's optimization problem is equivalent to maximizing

$$(2.10) \quad \max_{\{B_{F,t}^d, B_{L,t}^d\}} \quad E_t(W_{t+1}) - \frac{k}{2} \text{var}_t(W_{t+1})$$

where

$$(2.11) \quad E_t(W_{t+1}) = W_t(1 + r_t) + B_{L,t}^d(\rho_{L,t}) + B_{F,t}^d(\rho_{F,t})$$

$$(2.12) \quad \begin{aligned} \text{var}_t(W_{t+1}) = & (B_{L,t}^d)^2 \text{var}_t(r_{t+1}) + (B_{F,t}^d)^2 \text{var}_t(s_{t+1}) \\ & - 2(B_{L,t}^d)(B_{F,t}^d) \text{cov}_t(r_{t+1}, s_{t+1}) \end{aligned}$$

First order conditions with respect to  $B_{F,t}^d$  and  $B_{L,t}^d$  are respectively

$$(2.13) \quad \rho_{F,t} - k(B_{F,t}^d) \text{var}_t(s_{t+1}) + k(B_{L,t}^d) \text{cov}_t(r_{t+1}, s_{t+1}) = 0$$

$$(2.14) \quad \rho_{L,t} - k(B_{L,t}^d) \text{var}_t(r_{t+1}) + k(B_{F,t}^d) \text{cov}_t(r_{t+1}, s_{t+1}) = 0$$

Solving these FOCs for  $B_{F,t}^d$  and  $B_{L,t}^d$  gives demand functions for foreign bonds and domestic long-term bonds, respectively.

$$(2.15) \quad B_{F,t}^d[\rho_{F,t}, \rho_{L,t}] = \psi \cdot \rho_{F,t} - \psi \cdot \phi \cdot \rho_{L,t}$$

$$(2.16) \quad B_{L,t}^d[\rho_{F,t}, \rho_{L,t}] = \psi \cdot \frac{\sigma_s^2}{\sigma_r^2} \cdot \rho_{L,t} - \psi \cdot \phi \cdot \rho_{F,t}$$

where

$$(2.17) \quad \psi = 1/k\sigma_s^2(1 - \text{cor}^2)$$

$$(2.18) \quad \phi = -cov/\sigma_r^2$$

$$(2.19) \quad \sigma_s^2 = E_t[s_{t+1} - E_t(s_{t+1})]^2$$

$$(2.20) \quad \sigma_r^2 = E_t[r_{t+1} - E_t(r_{t+1})]^2$$

$$(2.21) \quad cov = E_t[\{s_{t+1} - E_t(s_{t+1})\}\{r_{t+1} - E_t(r_{t+1})\}]$$

$$(2.22) \quad cor = cov/(\sqrt{\sigma_s^2}\sqrt{\sigma_r^2})$$

The demand function for foreign bonds, Equation (2.15), depends on  $cov$ , the covariance conditional on  $\Omega_t$  between the exchange rate and the short-term interest rate, and  $\sigma_s^2$ , the conditional variance of the exchange rate. At the same time, the stochastic processes of the exchange rate and  $cov$  also rely on the demand function for foreign bonds. Therefore, it is required to solve for a rational expectation equilibrium in which the values of  $cov$  and  $\sigma_s^2$  are consistent with the stochastic process of the exchange rate implied by the demand function for foreign bonds. In the next section, the rational expectation equilibrium will be derived.

When the short-term interest rate rises, there exist two opposite effects on the demand for foreign bonds given the second moments of the exchange rate and the short-term interest rate. The first effect, called *the direct risk premium effect*, is from the first term of Equation (2.15). This effect is defined to be the change in the demand for foreign bonds when the short-term interest rate rises holding the risk premium for long-term bonds constant. This effect is equal to  $-\psi$  and is negative. The second effect, called *the indirect risk premium effect*, is from the second term of Equation (2.15). This effect is defined to be the change in the demand for foreign bonds when

the short-term interest rate rises holding the risk premium for foreign bonds constant. This effect is equal to  $\psi\phi$ . In the rational expectations equilibrium derived in the next section,  $cov$  is negative, which implies that the indirect risk premium effect is positive.

An intuitive explanation of the indirect risk premium effect is as follows: If the short-term interest rate unexpectedly rises, the price of a long-term bond falls and this drop causes long-term bond holders to suffer an unexpected capital loss. When  $cov$  is negative, the exchange rate tends to appreciate and it causes investors an additional unexpected loss if they hold foreign bonds. Therefore, as long as an increase in short-term interest rate is associated with an appreciation of the domestic currency, risk averse agents want to avoid holding both long-term bond and foreign bond. The greater the appreciation of the domestic currency caused by an increase in the short-term interest rate, the stronger the incentive to adjust a portfolio of risky assets toward holding more foreign bonds and less long-term bonds as the short-term interest rate rises. This indirect risk premium effect allows the demand for foreign bonds to increase when the short-term interest rate rises.

The existence of two counter forces on the demand for foreign bonds implies that the effect of a rise in the short-term interest rate on the demand for foreign bonds depends on the relative strength of these two effects. The indirect risk premium effect dominates the direct risk premium effect if and only if  $\phi > 1$ . Therefore,  $\phi$  may be referred to as the measure of the relative magnitude of the indirect risk premium effect. In the next section, it will be shown that  $\phi$  is greater than 1 under reasonable parameter configurations.

### 3 The Rational Expectation Equilibrium

In this section, the model presented in the previous section will be used to derive the demand for foreign bonds in the rational expectation equilibrium. The stochastic processes of interest rates are assumed to be as follows:

$$(3.1) \quad r_t = \mu + e_t + \varepsilon_t$$

$$(3.2) \quad R_t = \frac{1}{2}d + \mu + \frac{1}{2}(1 + c)e_t$$

$$(3.3) \quad r_t^* = \mu$$

$$(3.4) \quad R_t^* = \frac{1}{2}d + \mu$$

where  $e_t$  and  $\varepsilon_t$  are a persistent interest rate shock and a temporary interest rate shock, respectively. It is assumed that  $e_t$  follows an AR(1) process

$$(3.5) \quad e_t = ce_{t-1} + v_t, \quad \text{where } |c| < 1$$

and that it is independent of  $u_t$ . It is also assumed that  $\varepsilon_t$ ,  $v_t$  are white noise with variance  $\sigma_\varepsilon^2$  and  $\sigma_v^2$ , respectively, and that they are independent of each other and of  $u_t$ . Finally,  $d$  and  $\mu$  are positive numbers.

The conditional expectation is assumed to coincide with the best linear prediction. Since (3.2) is a fundamental representation in the sense of linear prediction theory (see, e.g., Rozanov (1967)), observing the current and past values of  $R_t$  is equivalent to observing the current and past values of  $e_t$  under an AR(1) process. It follows that

$$(3.6) \quad E_t(r_{t+1}) = \mu + ce_t$$

and from (2.3) and (3.6),

$$(3.7) \quad \rho_{L,t} = d - \varepsilon_t$$

For the purpose of this paper, we need to assume that the risk premium for long-term bonds,  $\rho_{L,t}$ , is nonzero. As is shown in (3.7), the assumption employed here is that only  $e_t$  is transmitted to the long-term interest rate, so that the risk premium is equal to the sum of the mean of long-term interest rate and a temporary interest rate shock.

Define  $\eta = \sigma_\varepsilon^2/\sigma_e^2$ , which may be called the measure of substitution between short-term bonds and long-term bonds. If  $\eta = 0$ , then the risk premium for long-term bonds will be the mean of the long-term interest rate, implying that the short-term bond and the long-term bond will become more substitutable. The greater the magnitude of  $\eta$ , the smaller the degree of the substitution.

Let  $L$  be the lag operator. Then the equilibrium condition in the period  $t$  is,

$$(3.8) \quad E_t[A_0(L)s_t] = a + D_0$$

where

$$(3.9) \quad A_0(L) = -\psi L^{-1} + (b + \psi)$$

$$(3.10) \quad D_0 = -u_t - B_{F,t-1}^s - \psi\phi d - \psi e_t + \psi(\phi - 1)\varepsilon_t$$

The equilibrium condition for period  $t + 1$  is, if we take expectations conditional on  $\Omega_t$  from both sides,

$$(3.11) \quad E_t[A(L)s_{t+1}] = a + D_1$$

where

$$(3.12) \quad A(L) = -\psi L^{-1} + (b + 2\psi) - \psi L$$



$$(3.13) \quad D_1 = \psi(1 - c)e_t - \psi(\phi - 1)\varepsilon_t$$

The equilibrium condition for  $t + \tau$  ( $\tau \geq 2$ ) is, if we take expectations conditional on  $\Omega_t$  from both sides,

$$(3.14) \quad E_t[A(L)s_{t+\tau}] = a + D_2$$

where

$$(3.15) \quad D_2 = \psi(1 - c)e_t c^{\tau-1}$$

Solving (3.8), (3.11), and (3.14) as a difference equation system of  $E_t(s_{t+\tau})$  with respect to  $\tau$  provides the unique saddle point solution,

$$(3.16) \quad s_t = \bar{s} - \left(\frac{1 - \lambda}{b}\right)u_t - \left(\frac{1 - \lambda}{b}\right)B_{F,t-1}^s - \left(\frac{\lambda}{1 - \lambda c}\right)e_t + \lambda(\phi - 1)\varepsilon_t$$

where  $\bar{s} [= \frac{a}{b} - (\frac{1-\lambda}{b})\phi\psi d]$  is the long-run equilibrium exchange rate clearing the current account, and

$$(3.17) \quad \lambda = 1 + \frac{b}{2\psi} - \frac{b}{2\psi} \sqrt{1 + \frac{4\psi}{b}}$$

It is shown that  $0 < \lambda < 1$ ,  $\partial\lambda/\partial\psi > 0$ ,  $\lim_{\psi \rightarrow 0} \lambda = 0$ , and  $\lim_{\psi \rightarrow \infty} \lambda = 1$ .

Equation (3.16) shows that the investor's expected values of  $cov$  and  $\sigma_s^2$  affect the exchange rate dynamics through  $\lambda$  and  $\phi$ . On the other hand, the exchange rate dynamics in (3.16) imply certain values of  $cov$  and  $\sigma_s^2$ , which need to be consistent with the investor's expected values in the rational expectation equilibrium. The equilibrium is analyzed in two steps. First, we solve for the rational expectation of  $cov$ . Second, we show the uniqueness and existence of the rational expectation equilibrium by solving for the rational expectation of  $\sigma_s^2$ .

Before solving for the equilibrium, note the nature of (3.16). The discrepancy between actual and long-run equilibrium exchange rates can be explained by several factors: the trade shock (the first bracket), the cumulative current account balance (the second bracket), the persistent interest rate shock (the third bracket), and the temporary interest rate shock (the fourth bracket). The trade shock, which tends to give rise to current account surplus, makes the domestic currency appreciate. As the cumulative current account balance becomes greater, the appreciation of the domestic currency increases; for an investor to have incentives to hold more foreign bonds, the domestic currency must appreciate at present, so that investors will anticipate it depreciating in the future. Prolonged increases in the short-term interest rate make the domestic currency appreciate. All of these effects are consistent with the expected directions. However, the temporary interest rate shock,  $\varepsilon_t$ , has a perverse effect if the relative magnitude of the indirect risk premium effect,  $\phi$ , is greater than one.

The term  $\phi$  may be obtained by solving for the rational expectation of covariance. Calculating  $cov = E_t[\{s_{t+1} - E_t(s_{t+1})\}\{r_{t+1} - E_t(r_{t+1})\}]$  from (3.1) and (3.16) by taking the one period lead yields

$$(3.18) \quad cov = -\left(\frac{\lambda}{1 - \lambda c}\right)(1 - c^2)\sigma_e^2 + \lambda(\phi - 1)\sigma_\varepsilon^2$$

Substituting the definition of  $\phi$ , (2.18), into (3.18), and solving for  $cov$  gives the rational expectation equilibrium;

$$(3.19) \quad cov = -\left[\frac{\lambda(1 - c^2) + \lambda\eta(1 - \lambda c)}{1 - \lambda c}\right]\left[\frac{1 - c^2 + \eta}{1 - c^2 + \eta(1 + \lambda)}\right]\sigma_e^2 < 0$$

Therefore, by (2.18),

$$(3.20) \quad \phi = \left[\frac{\lambda(1 - c^2) + \lambda\eta(1 - \lambda c)}{1 - \lambda c}\right]\left[\frac{1}{1 - c^2 + \eta(1 + \lambda)}\right] > 0$$

In the rational expectation equilibrium, the conditional covariance between the exchange rate and the short-term interest rate,  $cov$ , is negative and the measure of the relative magnitude of the indirect risk premium effect,  $\phi$ , is positive. This implies that the indirect risk premium effect is positive as is shown in the previous section. The main issue for the purpose of this paper is whether  $\phi$  is greater or less than one. In order to determine this, we will investigate the sign of

$$(3.21) \quad \phi - 1 = \frac{(1 - c^2)\{\lambda(1 + c) - 1\} - \eta(1 - \lambda c)}{(1 - \lambda c)\{1 - c^2 + \eta(1 + \lambda)\}}$$

In order to examine the sign of (3.21), we need to know how  $\lambda$  depends on the underlying parameters of the model. For this purpose, the existence and the uniqueness of the rational expectation equilibrium will be shown by solving for the rational expectation of the conditional variance of the exchange rate,  $\sigma_s^2 = E_t[\{s_{t+1} - E_t(s_{t+1})\}^2]$ . By taking one period lead of (3.16), we obtain

$$(3.22) \quad \sigma_s^2 = \left(\frac{1 - \lambda}{b}\right)^2 \sigma_u^2 + \left[\frac{\lambda^2(1 - c^2) + \lambda^2(\phi - 1)^2 \eta(1 - \lambda c)^2}{(1 - \lambda c)^2}\right] \sigma_e^2$$

By (3.19) and the definition of  $cor$ , (2.22),

$$(3.23) \quad cor = -\sqrt{\frac{(1 - c^2 + \eta)\sigma_e^2}{\sigma_s^2}} \cdot \left[\frac{\lambda(1 - c^2) + \lambda\eta(1 - \lambda c)}{(1 - \lambda c)(1 - c^2 + \eta(1 + \lambda))}\right]$$

By using the definition of  $\lambda$ , (3.17), we obtain

$$(3.24) \quad \psi = \frac{b\lambda}{(1 - \lambda)^2}$$

Substituting the definition of  $\psi$ , (2.17), into (3.24) gives

$$(3.25) \quad \frac{1}{k} = \sigma_s^2(1 - cor^2) \frac{b\lambda}{(1 - \lambda)^2}$$

The condition for the rational expectation equilibrium value for  $\sigma_s^2$  is obtained by substituting (3.22) and (3.23) into (3.25);

$$(3.26) \quad \frac{1}{k} = g(\lambda),$$

where  $g(\lambda) = \frac{\sigma_u^2 \lambda}{b} + \frac{b\sigma_e^2 \lambda^3 \{(1-c^2) + \eta(\phi-1)^2(1-\lambda c)^2\}}{(1-\lambda c)^2(1-\lambda)^2} - \frac{b\sigma_e^2(1-c^2+\eta)\lambda\{\lambda(1-c^2) + \lambda\eta(1-\lambda c)\}^2}{(1-\lambda c)^2(1-\lambda)^2(1-c^2+\eta(1+\lambda))^2}$

Let  $\lambda^*$  be the value of  $\lambda$  that satisfies (3.26). Any such  $\lambda^*$  corresponds to a rational expectation equilibrium. It can be checked that  $\lim_{\lambda \rightarrow 0} g(\lambda) = 0$ , and  $\lim_{\lambda \rightarrow 1} g(\lambda) = \infty$ . In particular, under the parameter configuration employed in the below Monte Carlo simulation, it can be shown that  $g'(\lambda) > 0$ . Hence, there exists a unique rational expectation equilibrium. Moreover, when  $k$  is smaller,  $\lambda^*$  is larger. It is shown that  $\lim_{k \rightarrow 0} \lambda = 1$  and  $\lim_{k \rightarrow \infty} \lambda = 0$ . The value of  $\psi$  can be obtained by substituting  $\lambda^*$  for  $\lambda$  in (3.24). The value of  $\psi$  is decreased by a reduction in the variances  $\sigma_u^2$  and  $\sigma_e^2$  and by an increase in the measure of constant risk aversion,  $k$ , which in turn diminishes  $g(\lambda)$ .

Equation (3.21) shows that  $\phi$  can be either greater or less than one, depending on the parameter values. One interesting case arises when the investor is close to being risk neutral. For a very small  $k$ , an approximate formula for (3.21) with  $\lambda \cong 1$  is

$$(3.27) \quad \phi - 1 = \frac{(1+c)c - \eta}{1 - c^2 + 2\eta}$$

Under  $\lambda \cong 1$  condition, we investigate what condition is required to exhibit the forward premium anomaly. The forward premium regression for short-term interest rate differential is

$$(3.28) \quad s_{t+1} - s_t = \alpha + \beta(r_t - r_t^*) + \text{error term}$$

Let  $\hat{\beta}$  be the estimate of  $\beta$ . If the estimator is consistent, it will be

$$(3.29) \quad \begin{aligned} \text{plim } \hat{\beta} &= \frac{\text{cov}(r_t - r_t^*, s_{t+1} - s_t)}{\text{var}(r_t - r_t^*)} \\ &\Rightarrow \frac{\text{cov}(r_t, s_{t+1} - s_t)}{\text{var}(r_t)} \end{aligned}$$

For  $\hat{\beta}$  to be negative, we need

$$\begin{aligned}
 (3.30) \quad & cov(r_t, s_{t+1} - s_t) < 0 \\
 & \Rightarrow cov(r_t, s_{t+1}) < cov(r_t, s_t) \\
 & \Rightarrow 1 < (\phi - 1)\eta
 \end{aligned}$$

However, substituting equation (3.27) into equation (3.30) does not produce a positive value of  $\eta$ . Instead, we conduct a Monte Carlo simulation<sup>5</sup> to investigate the forward premium anomaly.

Table 3.1: A Monte Carlo simulation for slope coefficient ( $= \beta$ ) of short-term regression

$$(s_{t+1} - s_t) = \alpha + \beta(r_t - r_t^*) + \text{error term}$$

$$H_0 : \beta = 0$$

$\phi$	1.6352 ( $\eta = 0.7$ )	2.7848 ( $\eta = 0.3$ )	3.5593 ( $\eta = 0.2$ )	5.1282 ( $\eta = 0.1$ )	9.0952 ( $\eta = 0.01$ )
mean of $\hat{\beta}$	0.2016	-0.3844	-0.7788	-1.5776	-3.5976
negative freq. <sup>1)</sup>	39.1	69.4	84.2	97.2	100.0
5 % level <sup>2)</sup>	1.9	8.5	18.0	49.6	93.2
(10 % level)	(3.7)	(13.8)	(28.1)	(62.5)	(96.8)

Note: 1) percentage of negative coefficients among total iteration(=1,000)  
 2) percentage of rejecting  $H_0$  among total iteration(=1,000) at five percent significance level.  
 Numbers in parentheses are that of ten percent significance level.  
 3) sample size is 102 and  $c = 0.9$

<sup>5</sup>We use Gauss for Windows NT/95 Version 3.2.38 to conduct it

Suppose the AR(1) coefficient of persistent interest rate shock,  $c$ , in equation (3.5) is close to one (for example,  $c = 0.9$ ), then  $\phi$  in equation (3.27) becomes greater than one as long as  $\eta < 1.71$ . When the investor is close to being risk neutral, the degree of substitution between short and long-term bonds must be high, and consequently,  $\eta$  should be very small. Under these parameter configurations, our model presented in the previous section predicts that as the measure of the relative magnitude of the indirect risk premium effect,  $\phi$ , is greater than one, the demand for foreign bonds increases as the short-term interest rate rises, resulting in the depreciation of domestic currency to cause an expected future appreciation of domestic currency. A Monte Carlo simulation based on these parameter configurations consistently generates a negative slope coefficient to show the forward premium anomaly. As table (3.1) shows, the stronger the indirect risk premium effect, the more statistically significant the negative slope coefficient.

On the contrary, a Monte Carlo simulation for long-term interest differential still generates a positive slope coefficient under the same parameter configurations as standard exchange rate model predicts.

Table 3.2: A Monte Carlo simulation for slope coefficient ( $= \beta$ ) of long-term regression

$$(s_{t+2} - s_t) = \alpha + \beta(R_t - R_t^*) + \text{error term}$$

$$H_0 : \beta = 0$$

$\phi$	1.6352 ( $\eta = 0.7$ )	2.7848 ( $\eta = 0.3$ )	3.5593 ( $\eta = 0.2$ )	5.1282 ( $\eta = 0.1$ )	9.0952 ( $\eta = 0.01$ )
mean of $\hat{\beta}$	1.0267	1.0274	1.0278	1.0287	1.0309
positive freq. <sup>1)</sup>	92.2	91.9	92.1	91.3	87.0
5 % level <sup>2)</sup>	30.9	30.0	29.3	28.4	20.8
(10 % level)	(43.9)	(43.1)	(42.1)	(39.2)	(30.8)

Note: 1) percentage of positive coefficients among total iteration(=1,000)

2) percentage of rejecting  $H_0$  among total iteration(=1,000) at five percent significance level. Numbers in parentheses are that of ten percent significance level.

3) sample size is 102 and  $c = 0.9$

## 4 Conclusion

In this paper, we derive the demand function for foreign bonds endogenously by solving for the rational expectation equilibrium and investigate how a rise in the short-term interest rate affects the demand for foreign bonds. It generates two opposite effects on the demand for foreign bonds. The direct risk-premium effect comes from the fact that risk averse agents with short investment time-horizons want to reduce the demand for foreign bonds to increase the amount invested in risk free assets. On the other hand, investors have another incentive, the indirect risk-premium effect, to increase the demand for foreign bonds to minimize potential capital losses resulting from holding both risky assets. We show that, under reasonable parameter

configurations, the indirect risk-premium effect can even dominate the direct risk-premium effect causing demand for foreign bonds to increase. In this case, the forward premium anomaly about the short-term interest rate can be explained; the domestic currency depreciates now, creating expected future appreciation of the currency. For the long-term interest rate differential, this model still shows the same prediction on the exchange rate like standard exchange rate models. Byeon and Ogaki (1999) find such results for many of the G7 countries with cointegrating regressions of real exchange rates onto the short-term and long-term interest rate differentials. Ogaki and Santaella (2000) obtain similar results for Mexico.

If the indirect risk-premium effect is quantitatively important, then the effectiveness of central bank attempts to affect exchange rate by controlling the short-term interest rate depends on whether the long-term interest rate responds to changes in the short-term interest rate. Anecdotal evidence suggests that further empirical investigation is warranted. For example, from the middle of March 1982 to the end of November 1982, the Bank of Japan adopted a policy to increase the domestic short-term interest rate in order to cause an appreciation of the yen (see, e.g., Komiya and Suda [1983, pp. 347-354]). The short-term interest rate in Japan increased but the yen tended to depreciate, rather than appreciate, against the U.S. dollar during this period. One remarkable fact was that the long-term interest rate did not increase when the Bank of Japan began to increase the short-term interest rate (Komiya and Suda [1983, p.349]).

The model in this paper suggests that much more complicated relationship might exist between the term structure of interest rates and the exchange rate than is implied by exchange rate models with risk neutral agents. In addition, the model can



be applied to the relationship between exchange rate and the term structure of various short-term rates if the investment horizon is very short (e.g., 1 month or shorter). In this sense, the model could help explain Clarida and Taylor's (1997) finding that the information of the term structure of 1-month to 12-months forward premiums is useful in predicting future exchange rate.

There has been little empirical work on the interaction between the exchange rate and the term structure of interest rates relative to the large volume of empirical work on the exchange rate. Further empirical investigation is warranted.

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