Covered Interest Rate Parity: The USD and CNY

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One of many tests of international finance is a test termed Covered Interest Rate Parity (CIRP). This theorem posits that exchange rate forward premiums (discounts) are offset by the respective interest rate differential between two currencies (Bhargava, Dania, & Malhotra, 2011). To briefly describe another theorem of interest rate parity is the Uncovered Interest Rate Parity (UIRP). This theorem posits that a return on an uncovered foreign currency deposit should be equal to the return on a similar domestic deposit despite the national market the foreign deposit is located. It is essential to recognize the two theorems to understand that the CIRP is offset by the spot/forward currency premiums and that a violation of this relationship indicates an arbitrage opportunity (Bhargava, Dania, & Malhotra, 2011). This assignment will address the covered interest parity on the United States dollar and the Chinese Yuan.

Covered Interest Rate Parity

According to Adrangi, Allender, and Raffiee (2003), if the Interest Rate Parity (IRP) equilibrium condition does not hold, capital markets may not be efficient; therefore, opportunities for money managers, hedge funds, and other speculators to exploit market misalignments for profit may exist (Adrangi, et al., 2003). Additionally, as long as the IRP is not in the equilibrium, arbitragers will conduct CIRP arbitrage as long as the interest rate differential is more than the spot-forward differential (Adrangi, et al., 2003).

Study between BRIC Nations and the United States

During 2004-2008, a study was performed using the covered interest rate parity for emerging markets of Brazil, Russia, India and China (BRIC) with the United States being the major trading partner. What was tested was whether the CIRP holds for emerging market of the
BRIC countries. In fact, evidence shows that CIRP does not hold. Several reasons can be presumed; however, what was shared is the existence of profitable arbitrage opportunities (during that period). It must be noted that the study yielded a good scale to test CIRP condition since the nations had a high level of trade between them and the United States. That ensured demand and exchange of currencies.

**Chinese Yuan and IRP**

To reflect on previous research performed throughout this course observing the Chinese Yuan and the United States Dollar, one question that may arise is the role of the Yuan and IRP in the midst of devaluation claims? An article that clearly addresses the claims provides valuable information that sheds light on the situation. Referenced before is Haque (2014). According to Haque, IRP theory mentions that in the country that has higher interest, the value of their currency will depreciate in the forward market so that no one can make a gain by taking advantage of interest rate differential. I shared in my post this week a good example of this theory. In other words, if the United States has a higher interest, the value of the United States money will decrease in the forward market so that no other country can gain by taking advantage of interest rate differential. For instance, if the interest rate is 5.93% in the United States and 4.35% in China, investors in China will borrow in China, convert to United States currency, and invest in the United States. Though, at the end of the investment period, when they try to convert United States currency to Chinese currency, the value of the dollar will have decreased, wiping out any gain made due to the higher interest rate in the United States.

In our textbook, it is stated that interest rates provide prices for moving currencies between different time periods or from current to the future, which is said to be in the time values of monies. Moreover, to add exchange rates to the fusion, it provides the prices for
moving from one currency to another currency either today for the spot rate or in the future period for the forward rate (Bekaert & Hodrick, 2012).

Again, the theory (IRP) holds that one cannot make arbitrage profits due to different interest rates in various countries. Therefore, any gain made because of the interest rate differentials will be wiped out due to adjustment in the exchange rate at the end of the investment time horizon. To add to my example given earlier, what if the three-month interest rate in the United States is 12.93% and the same three-month rate in China is 4.35%. That would show that investors in China would transfer their funds to the United States to capitalize on the higher interest rates and to earn a higher return. Although, this sounds ideal and somewhat too good to be true, according to IRP, this is not true. The theory of interest rate parity holds that such arbitrage chance is not possible because after three months the U.S. dollar is expected to depreciate by approximately 4 percent let’s say (Haque, 2014). Additionally, the Chinese investor will not gain at the end of that time period because the return in the United States will be wiped out due to the value declining at the end of three months when the investor converts the dollar to yuan.

As we have learned throughout this course, risk sometimes is inevitable; therefore, this transaction can be viewed as an exchange rate risk. To avoid such as risk, the Chinese investor, in this case, can at the same time purchase the dollar in the spot market and sell the dollar in the forward market. There is a possibility of an increase in the dollar in the spot market while a decrease in value in forward market. That will eliminate any arbitrage profit. In the case of China and the controversy surrounding the Yuan, it is safe to say that political pressures certainly plays a role in both interest and exchange rates. As I have reported over the past four weeks, there is an unwillingness to allow the Yuan to freely float due to a number of reasons, but mainly political
pressures, although exchange rates can be beneficial to all. There seems to be conflicting interest of exchange rate policy and its supporters and opponents. Nevertheless, those individuals try to influence the government to have exchange rate policy to appreciate local currency while the lobbyists of the producers want exchange rate policies to depreciate the local currency (Ester, Massimo, Michele, 2008).

Conclusion

As I have addressed in this paper, there are many tests of international finance; however, the test covered in this paper is the Covered Interest Rate Parity (CIRP). This theorem posits that exchange rate forward premiums (discounts) are offset by the respective interest rate differential between two currencies (Bhargava, Dania, & Malhotra, 2011). Additionally, another theorem of interest rate parity is the Uncovered Interest Rate Parity (UIRP). This theorem posits that a return on an uncovered foreign currency deposit should be equal to the return on a similar domestic deposit despite the national market the foreign deposit is located. It is essential to recognize the two theorems in order to understand that the CIRP is offset by the spot/forward currency premiums and that a violation of this relationship indicates an arbitrage for some involved opportunity (Bhargava, Dania, & Malhotra, 2011).
Reference


