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The "forward premium puzzle" and the sovereign default risk

Carry-trade strategies which consist of buying forward high-yield currencies tend to yield positive excess returns during tranquil periods, whereas they generate losses during crises. Here, we show that the sovereign default risk, which is taken on by investing in high-yield currencies, may increase the magnitude of the gains during the tranquil periods and the losses during crises. We empirically test for this hypothesis on a sample of 18 emerging currencies over the period from June 2005 to September 2010, the default risk being proxied by the sovereign credit default swap spread. Relying on smooth transition regression (STR) models, we show that default risk contributes to the carry-trade gains during calm periods, and worsens the losses during crises. We then introduce the default risk into the “Fama regression” linking the exchange-rate depreciation to the interest-rate differential. The “forward bias”, usually evidenced by a coefficient smaller than unity in this regression, is somewhat alleviated, as the default risk is significant to explain the exchange-rate change.

(This is joint work with V. Mignon.)