

Is the foreign exchange market ‘risky’? Some new survey-based results

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Abstract

In this paper we examine the evidence in favour of time-varying risk premia for four foreign exchange markets. The main novelty in our work is that we use survey-based expectations data to generate risk premia, rather than exploiting the rational expectations assumption. In contrast to the perceived wisdom on the existence of a foreign exchange risk premium, we present positive evidence for the view that risk is an important variable in foreign exchange markets. © 2000 Elsevier Science B.V. All rights reserved.

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1. Introduction

It has become something of a stylised fact that the forward market for foreign exchange is inefficient, in the sense that the forward premium is a biased predictor of the actual exchange rate change¹. Two main interpretations have been given for this finding: either it reflects a time-varying risk premium (Fama, 1984), some form of expectational failure, such as a ‘peso’ effect (Krasker, 1980), learning (Lewis, 1989) or simple irrationality (Bilson, 1981). A considerable amount of research

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¹ See Hodrick (1987) and Engel (1996) for comprehensive overviews of this literature.

effort has been devoted to discerning which of these interpretations is responsible for the rejection, with the largest effort being devoted to the risk premium interpretation. Conditional on the assumption of rational expectations, a number of researchers have sought to test for the existence of a time-varying foreign exchange risk premium and also attempted to model it. A fair assessment of this literature would be that the evidence in favour of a risk premium is rather limited². More positive results have been reported by researchers who have sought to interpret the biasedness result as stemming from the expectational failures of risk neutral agents. This literature has involved using forward forecast errors to generate trading rules which turn out, in an *ex post* sense, to be profitable (Bilson, 1981; Bilson and Hsieh, 1987; Marsh and Power, 1996).

A problem with either the risk premium or expectational interpretation of forward rate biasedness is that it is just that—an interpretation. In order to avoid taking a position on whether agents are risk neutral and/or rational, a number of researchers have advocated using survey data on foreign exchange market participants expectations of exchange rates (see, *inter alia*, Frankel and Froot, 1987, 1989, 1990; Dominguez, 1986; MacDonald and Torrance, 1988, 1990; MacDonald, 1990b, 1992; Cavaglia et al., 1993, 1994; Frankel and Chinn, 1993; MacDonald and Marsh, 1994, 1996; Chinn and Frankel, 1994). This research may be thought of as trying to decompose the measure of forward rate biasedness, recorded in numerous regression results, into a component due to risk and a component due to irrationality³. A fair summary of this burgeoning literature is that it suggests that both irrationality and time-varying risk premia are responsible for the rejection. However, all of the above-noted survey tests are concerned with testing for the existence of time-varying risk premia. None, to our knowledge, actually attempts to empirically model the risk premium generated from survey data. This is the purpose of the present paper. Our approach is wholly empirical. In particular, we use survey data collected by Money Market Services (UK) to construct risk premia for four currencies. We then analyse the time series properties of these premia using different time series methods. In contrast to practically all of the extant literature which exploits the rational expectations assumption to construct risk premia, we report a considerable amount of evidence supportive of time-varying risk premia.

The outline of the remainder of this paper is as follows. In the next section we define the survey- and rational expectations-based foreign exchange risk premia and briefly discuss two models which facilitate the pricing of foreign exchange risk. In Section 3, the data set used in the paper is defined. In Section 4, ARCH and GARCH models are used to generate explanatory variables for the risk premium. The paper closes with a concluding section.

² See, for example, Hodrick (1987), Engel (1996) and MacDonald (1988, 1990a).

³ See Frankel and Froot (1989) for a formal derivation of this decomposition for the slope coefficient in a regression of the exchange rate change on the forward premium.

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