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Exchange risk premia, expectations formation and “news” in the Mexican peso/U.S. dollar forward exchange rate market

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Abstract

In this article, we investigate expectations concerning the Mexican peso/US dollar exchange rate with the aid of a survey dataset containing market participants' forecasts of the exchange rate and of the interest differential between the peso and the dollar. Our findings indicate that the survey expectations were off by a large and significant constant. At the same time, large average risk premia, as well as time variance in the risk premia, were detected. As to the expectations formation mechanism, market participants tended to react to current (unanticipated) depreciations by expecting future depreciations at the 3-, 6-, and 12-month horizons, as implied by destabilizing expectations models. “News” about the interest differential did not contribute additional predictive power with regard to the peso/dollar exchange rate once a risk premium term is included in a regression equation. Interestingly, a Dornbusch-type overshooting effect is present in the Mexican data. © 2001 Elsevier Science Inc. All rights reserved.

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1. Introduction

The debate regarding the empirical finding that the forward discount is a biased predictor of the future change in the exchange rate continues to be an issue of central concern in the

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international financial economics literature (for instance, see the surveys on the efficiency of the forward foreign exchange markets by Engel, 1996; Hodrick, 1987). The early empirical evidence suggests that future exchange rate changes and current interest differentials (i.e., the forward discount) are negatively correlated. That is, relatively high domestic nominal interest rates predict appreciation of the domestic currency. The rejection of forward market efficiency may be attributable to the irrationality of market participants, to the existence of time-varying risk premia, learning about a policy change, or to some combination of these phenomena (see, e.g., Cavaglia, Verschoor, & Wolff, 1993a, 1993b, 1994; Frankel & Froot, 1987a, 1987b; Froot & Frankel, 1989; Lewis, 1995).

Interestingly, this branch of literature concerning the forward discount bias pays little attention to emerging and the lower-income developed economies.¹ In the current article, we aim to provide statistical evidence on the nature of the forward discount bias for the Mexican forward exchange rate market using survey expectations of the Mexican peso/US dollar exchange rate. By gathering independent measures of expectations, it is possible to decompose the forward discount bias into separate components attributable to risk premia and to expectational errors. The study complements previous work that has largely focused on analyzing survey data for the five most actively traded currencies vis-a-vis the US dollar, and on EMS currencies. In addition, we address the question that was considered earlier by Cavaglia et al. (1993a) and Frankel and Froot (1987a): Which time series process best characterizes investors' expectations formation?

In the past two decades, the asset market approach has become the principal tool for analyzing movements in exchange rates. From the time when expectations were first introduced into this approach to exchange rate determination, it has been recognized that unexpected events have a qualitatively different effect on the exchange rate from anticipated developments.² The exchange rate should change discontinuously in response to new pieces of unanticipated relevant information, whereas anticipated discrete changes are ruled out, since they would represent an unexploited profit opportunity. The asset market approach typically places considerable emphasis on the importance of expectations and changes therein and is generally taken to imply that empirical research on the determinants of exchange rates should relate innovations in exchange rates to innovations in expectations about relevant future fundamentals. In the empirical literature, this approach is often referred to as the "news" approach of exchange rate determination. Since expectations are inherently unobservable, any empirical study on the "news" approach involves choosing a specific model of the process of exchange rate determination and an appropriate method of generating expected values of its driving values. In this article, we follow an alternative route and investigate empirically the relationship among exchange rate returns, "news," and risk premia using survey data of *matched* Mexican peso/US dollar exchange and interest rate expectations, thereby at least partially avoiding the problem of artificially generated expectations when using an econometric technique.

¹ One interesting study is worth noting. Bansal and Dahlquist (1999) provide empirical evidence regarding the "forward premium puzzle" obtained from emerging and developed economies.

² See Frenkel and Mussa (1980). Black (1973) was an early introduction of rational expectations and a test of anticipated vs. unanticipated effect of news reports.

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