# Covered interest rate parity condition and why it holds case study

Finance, Investment

In the context of international trade, the term “ Covered Interest Rate Parity” implies to the situation in which there exists equilibrium between interest rates and forward and spot currency values of two economies. Consequently, there are no opportunities for arbitrage between these two currencies. As an illustration, consider nation A, whose currency is trading at par with nation B’s currency, (Robert, 2005, pp. 21-6). However, the rate of interest in A is 5% while in B is 2%. Ceteris paribus, it would be beneficial to borrow currency of nation B, change it in the spot market to the currency of nation A and then invest the takings in nation A. But, one has to enter into the forward contract to convert back currency from nation A to that of nation B, so has to repay the loan in currency B. Based on this illustration, if the forward rate of changing A to B wipes out all the profits in this dealings, covered interest rate parity is said to hold. Therefore, it can be argued that the covered interest parity condition holds due to the fact that there is equilibrium between interest rates and forward as well as spot currency values between the given two countries. Mathematically, this condition can be explained as; (1+i$) = (F/S) (1 +ic) where; S is the spot exchange rate, F is the forward exchange rate.

## Economic meaning of the condition

There are various economic implications of this condition. As noted above, there are no opportunities of arbitration in this case based on the fact that, the interest rate is equal to the spot and forward rates. Therefore, it does not pay to undertake any speculations as the same outcomes are expected whether one invests in home country or in another country. As a matter of fact, this implies that foreign investment in the concerned countries will be

very minimal. Economically, this might lead to poor economic performance in both countries on the basis on the claim that there is minimal inflows and outflows of money in these countries, (Robert, 2005. Pp. 10-3) Arguably, the main reason why there will be poor economic performance is that, investment plays a significant role in economic performance and in this case, the rate of investments in both countries goes down due to minimal cash inflows.

## Factors preventing it from holding

Arguably, covered interest rate parity condition is very rare to hold based on various reasons. As mentioned early, for this condition to hold, an assumption is made that all factors that may influence interest rates are held constant. However, it is very difficult if not impossible for these factors to be constant. Notably, other costs are involved in these transactions. For instance, transport costs are incurred in the process of undertaking these transactions. Secondly, spot rate keeps on changing from time to time, (Michael & Peter, 2002, pp. 12-8). Therefore, the existing spot might be different with the spot rate which would be applicable in future. Lastly, other economic factors which have an impact on interest rates may also change in the future. For example, prices that are applicable now in home country may not be the same prices that will be applicable in future. Thus, speculation about future interest rates is very difficult, which explains the reason why the covered interest rate parity condition is not easy to be realized.

## The condition today and in 1940s & 1950s

Based on the economic conditions existing in the recent times, it can be asserted that covered interest rate parity does not hold closely as compared to in the 1940s and 1950s. In comparison to 1940-1950, most economies are less stable. Factors that influence the rates of interest have also increased and are never constant. Therefore, it is very difficult for this condition to hold lately as compared to how it could in the above mentioned period.

## Covered interest rate parity today in China and U. S.

From my point of view, currently, the covered interest rate parity condition does not hold for investments made in U. S. and China. As a matter of fact, the United States is one of the countries that were significantly affected by the recent economic crisis as compared to china. Therefore, the conditions necessary for this condition to hold do not exist. Another thing is that, spot rates in these two countries are quite different and keeps on changing from time to time, which makes it difficult to speculate for future spot rate, (Michael & Peter, 2002, pp. 20-5). Besides, the forward exchange rates are also never constant. To be more precise, the dollar is more volatile currently making it difficult to evaluate the connection between current and future spot interest rates.

## Purchasing power parity

Purchasing power parity is a premise which asserts that the rates of exchange between currencies will be at par or rather equilibrium when they will have the same purchasing power in two countries. Based on this definition, it is implied that the ratio of the price level in both countries will

be equal to the rate of exchange between the two countries. As such, in case the domestic price level of a given country increases, its rate of exchange must reduce or rather depreciate so has to return to the purchasing power parity, (Alan and Mark, 2004, pp. 135-0) Mathematically, purchasing power parity can be represented as; E = P1/P2 where, E is the rate of exchange of currency 1 to currency 2, P1 is the cost of good ‘ y’ in currency I, while P2 is the cost of good ‘ y’ in currency 2. Perhaps, purchasing power parity can be said to be a premise of determining rate of exchange as well as a way of comparing the average costs of services as well as goods between various countries. In most cases, PPP are calculated in two ways; relative PPP and absolute PPP. Absolute PPP is as described above while in relative PPP uses rates of inflation.

## Why it holds

Arguably, purchasing power parity holds based on the law of one price. According to the law of one price, the price of identical goods should be the same in two detached markets, based on the assumption that there is no transportation to be incurred as well as taxes applicable are the same in both markets. To be more specific, the price of alike goods in separate markets in two countries will be equal when the price is determined in the same currency, assuming that there are no transaction as well as transportation costs, (Alan and Mark, 2004, pp. 142-6) For this law to hold, there must be no other costs as mentioned above, competitive markets should be existing in both countries, and also, the goods involved should be tradable.

## Evidence on ppp

As a matter of fact, PPP is one of the theories that clarify the long-run performance of the rates of exchange. One of the ways in which PPP can be evaluated is comparing the prices of identical goods in one basket in two different countries. For instance, in America, the Economist many a times use the price of Mac hamburgers from McDonald in most parts of the globe and weighs against the dollar at the exchange rate market to measure whether there is an undervaluation or overvaluation of a currency relative to value of the dollar at the current exchange rate. In 2004, in China, the price of burger was $ 1. 20 and in America it was $2. 25. This was an implication that China’s yuan was undervalued by approximately 56%. From this illustration, it can be stated that purchasing power parity does not hold due to the fact that the price of burger in China was different from the price of the same in America, (Alan and Mark, 2004, pp. 145-0)

## Why deviations in ppp

Undeniably, it is evident that there is some degree of deviations from the purchasing power parity. As mentioned previously, purchasing power parity is based on the law of one price, which is also developed under various assumptions. However, has been asserted that these assumptions do not hold; hence, the deviations that are observed in the purchasing power parity. For instance, it is assumed that there is no transport cost in this context. However, transport and transaction costs are inevitable in this case, (Alan and Mark, 2004, pp. 150-8). Additionally, it is very rare for all goods to be

traded between countries, and the weights that are attached to identical goods are quite different from one country to another.

## Fixed and flexible exchange rates

Fixed exchange rate or rather pegged exchange rate has it is sometimes called, refers to a system of exchange rate in which the value of a currency of a given country in relation others, is kept at a given rate of conversion. This is usually done through the central bank or by the intervention of the government. On the other hand, in the case of flexible exchange rate, there is no intervention from; either, the government or the central bank. Therefore, the main difference between these two regimes of exchange rate is that in the case of fixed exchange rate, the rate at which a currency of a given country will be converted to other currencies is predetermined by the government through the central bank, while on the other hand, in the flexible exchange rate regime, the rate of conversion of a currency of a given country is determined by the forces of demand and supply and not interventions from the government, (Mundell, 2007, pp. 30-5)

This difference is very crucial for a country with significant inflows and outflows of capital within the economy. For such a country, it will greatly benefit by opening its economy which will promote capital flows. Therefore, best alternative for the country is to use the flexible exchange rate system, (Sebastian, 2000, pp 23-9). As mentioned previously, the forces of demand and supply determine the rate at which a currency will be exchanged under this regime. As such, based on the fact that there is sufficient flow of capital

in this case; therefore, there is no need to keep more reserves needed to control exchange rates like is in the case of the fixed exchange regime.

## Determinants of current financial crisis

The recent financial crisis can be attributed to various factors. To begin with, there have been speculations of an increase in the interest rates. Interest rate were expected to increase as an upward trend was observed based on the fact that, the demand for loans was increasing making vulnerable the financial status of most banks, (Liliana & Laura, 2009, pp. 2-9). Secondly, there was a decline in the stock of prices. This contributed to a decrease in the value of asserts in the market which threatened the lending activities of most banks as the value of collateral declined. Thirdly, the speculated decline in prices stimulated a decline in the value of assets, mortgage and housing as well as a rise in the cost of debts. Fourthly, is a rise of uncertainty as most financial institutions were running bankrupt, which in turn reduced investment activities. Lastly, there was panicking of banks. As signs of bank failure started to appear, individuals started withdrawing their savings which led to a reduction in the funds for lending, which ended up limiting economic activities.

## Is it similar to past crises

Arguably, this crisis has some similarities with past crisis. In the 1980s, New York and Tokyo stock exchange collapsed. This marked the beginning of the failure of a good number of various financial and forex crisis. The financial depression that started in Asia in 1997 was activated by the fall Thai bacht and it was felt in the entire world as it negatively affected economic growth

of many countries, (Liliana & Laura, 2009, pp. 15-20). Like the various crisis, the recent crisis started as early as in 2008 once Lehman brothers were declared bankrupt. This marked the beginning of the volatility of the prices of assets, which developed to the recent economic challenges that have been experienced.

## Policies to use to prevent the crisis

Some of the possible strategies or rather policies that would help cure this crisis are; promoting investments and savings rather than consumption, availing resources as well as giving loans to medium and small firms so as to initiate economic growth, productivity and employment, and lastly, effecting transparency and accountability, (Liliana & Laura, 2009, pp. 10-14).

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