



Carry Trade



Mouna Pyneni



Uncovered Interest Rate Parity

- A parity condition stating that the difference in interest rates between two countries is equal to the expected change in exchange rates between the countries' currencies.
- If this parity does not exist, there is an opportunity to make a profit.
- Carry trade
- Borrowing in a low interest rate currency and lending at the higher interest rate

Not profitable in theory, but profitable in practice

In theory ,

- Increased borrowing of LIC ($r \uparrow$)
- Convert into HIC (value \uparrow)
- Increased purchase of HIC denominated money market instruments and increase in price, results in low yield ($r^* \downarrow$)
- Increased selling results in HIC value to decrease (value \downarrow)



Interest Rates for Different Countries

Country	Current Interest Rate	Previous	Last Change
Australia	3.25%	4.25%	Feb 03 2009
China	5.31%	5.58%	Dec 22 2008
India	5.50%	7.50%	Jan 02 2009
Japan	0.10%	0.30%	Dec 19 2008
European Monetary Union	2.00%	2.50%	Jan 15 2009
United Kingdom	1.00%	1.50%	Feb 05 2009
Canada	1.00%	1.50%	Jan 20 2009
United States	0.25%	1.00%	Dec 16 2008
Brazil	12.75%	13.75%	Jan 21 2009



- Several tradable carry trade index families have been launched over the last year.
- Combination of a long position in one or more high-yielding currencies with a short position in one or more low-yielding currencies.
- The simple approach (used by the Deutsche Bank) is to equally weigh the three lowest-yielding and highest-yielding currencies.
- The sophisticated approach (used for the CSFB and Barclays indices) uses mean-variance optimization when choosing the index weights, which implies lower aggregate weights on highly correlated currencies.



Characteristics of selected carry traded indices

Index family	Originator	Inception	Structure	Asian currencies referenced
CSFB Rolling optimised carry trade indices	Credit Suisse First Boston	April 2007	Reallocation every month across 10 major	+ EM currencies AUD, JPY, NZD, SGD
GEMS Asia Index	Barclays Capital	March 2007	Five currencies one month forward vs EUR or USD	IDR, NDR, KRW, PHP THB
DB Harvest	Deutsche Bank	March 2007	Reallocation every month across 10 major and 11 EM currencies	AUD, JPY, KRW, NZD, SGD, THB, TWD
Intelligent Carry Trade Index	Barclays Capital	March 2007	Reallocation every month across 10 major currencies	AUD, JPY, NZD



SIZE

- A conservative official Japanese statistics, estimates carry trade to be worth between \$80 billion and \$160 billion (2006).
- A better estimate based on the record of net "short" positions in yen futures on the Chicago Mercantile Exchange (\$1 trillion).



Conclusion

