

Exchange Rate Risk, Transactions Costs and the Forward Bias Puzzle

Angelo Ranaldo
Senior Economist
Swiss National Bank

Asani Sarkar
Research Officer
Federal Reserve Bank of New York

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ABSTRACT

We seek to explain the forward bias puzzle by introducing measures of foreign exchange risk and illiquidity in the context of a Vector Error Correction (VECM) model. The structure allows us to explicitly consider the cost and risk of trading to arbitrageurs and, therefore, to account for factors responsible for deviations from the expectations hypothesis. We find that risk aversion and transactions costs mitigate the forward bias puzzle. For many currency pairs, the sign of the forward premium coefficient switches from negative and significant to positive and significant after incorporating lagged values of illiquidity and volatility. For all currency pairs, the forward premium coefficient becomes less negative.