

Risk-adjusted Covered Interest Parity: Theory and Evidence

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Summary

We extend the theory of covered interest parity (CIP), aligning the different risks involved in uncollateralized money market transactions and collateralized foreign exchange (FX) swap transactions, which underscore CIP deviations in times of elevated uncertainty. We postulate that the swap dealer behaves as if he tries to filter out the counterparty risk embedded in money market rates in pricing FX swaps. Our results suggest that he does so not only during turbulent times but also under normal market conditions. The extended theory also uncovers a simple way to disentangle counterparty and liquidity risk premiums embedded in money market rates.