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journal homepage: www.elsevier.com/locate/frlThe effect of political risk on currency carry trades[☆]

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ABSTRACT

This paper explores the risk profile of individual currency carry trades. Findings indicate that carry trade profitability depends on a country's political risk, supporting the risk-based view on forward bias. Political risk effect originates as a component of government actions and is more pronounced in emerging economies and in countries with high interest differentials.

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1. Introduction

This paper investigates the risk characteristics of currency carry trades. The international economics phenomenon of carry trade has its roots in macroeconomic parity condition failures owing to the inefficiency of the forward rate in forecasting a future spot rate, referred as the forward premium puzzle. Several studies argue that this puzzle can be explained by a carry trade exposure to a common risk, owing to fundamental differences between countries (Hansen and Hodrick, 1980; Fama, 1984). The contribution of this study lies in revealing that currency carry trade profitability depends on a country's political risk characteristics, thus providing new support for the risk-based view on the forward premium puzzle.

Despite the abundance of research searching for rational risk premia, only a few studies have attempted to explain forward bias as a risk premium originating from political risk. Bachman (1992) shows that political regime changes between 1973 and 1985 in the major developed countries can affect forward bias. Bernhard and Leblang (2002) argue that democratic processes (in eight industrial countries between 1974 and 1995) distorted forward rate forecasting ability, and thereby contributing to resolving the forward premium puzzle. Capitalizing on previous evidence, the current research adopts a large set of carry trades (48 currencies over the period 1985–2013) and investigates a comprehensive set of political risk components with the goal of comprehending the determinants of carry trade returns and, thereby, forward bias.

The findings of this paper indicate that political risk may contribute to the existence of the forward premium puzzle. In particular, carry trade returns are high/low in countries with high/low values of composite political risk measure. However, we show that the political risk effect originates in emerging economies, while it is not evident in developed countries. Further, we find that only the competence of government actions as a stand-alone component of political risk endures the adjustment for common risk factors. Finally, political risk is priced only in the subsample of high interest rate differential

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countries. To sum up, evidence suggests that individual carry trades are heterogeneously exposed to political risk that, potentially, makes it more difficult for economic agents to predict future spot exchange rates of politically distressed countries, reinforcing the forward premium bias.

The remainder of the study is organized as follows. Sections 2 and 3 describe the data and the empirical strategy, respectively. Section 4 presents the results, followed by Section 5 that concludes the paper.

2. Data

The full sample comprises 48 monthly spot exchange rates and one-month forward rates obtained from Thomson Reuters Datastream. The sample of currencies is identical to that in Menkhoff et al. (2012) and the sample period spans 01/1985 to 12/2013. Data quotes are in units of foreign currency per U.S. dollar. It should be noted that the effective sample size varies widely for some currencies due to the availability of data quotes. Data on the political risk measure and its components for each of the 48 countries were acquired from the International Country Risk Guide (ICRG) of the Political Risk Services Group. The data periods are matched. The political risk measure is in the form of annual rating scores for each individual country, where the country risk is inversely related to the score. In addition, we organized the components of political risk into four subgroups as in Bekaert et al. (2014), those subgroups being: quality of institutions, conflicts external/internal, democratic tendencies, and government actions.¹

3. Empirical strategy

Monthly currency excess returns (r_{t+1}^i) are defined as follows:

$$r_{t+1}^i = f_t^i - s_{t+1}^i \quad (1)$$

where f_t^i stands for the log forward rate in units of foreign currency i per U.S. dollar in month t and s_{t+1}^i denotes the log spot exchange rate in the following month. Note, under covered interest parity log forward discount ($f_t^i - s_{t+1}^i$) approximates interest rate differentials ($i_t^i - i_t^{US}$). In a similar way to Moskowitz et al. (2012), we construct monthly individual carry strategies that go long (short) in the foreign currency if forward discount was positive (negative) in the previous month. Subsequently, carry returns are placed on an equal footing with political risk data by taking average monthly returns for the year in question, resulting in an unbalanced panel dataset with yearly observations.

In addition, we controlled for currency-specific risk factors, namely the dollar (DOL), the carry (HML) and the volatility (VOL) risk factors, as constructed by Lustig et al. (2011) and Menkhoff et al. (2012).² Moreover, we partitioned the sample into *developed* (10 countries) and *emerging* (31 countries) subsamples based on their classification by the MSCI and into *low*, *medium* and *high* carry trade subsamples of equal size based on historical average forward discounts ($\bar{f}^i - \bar{s}^i$).

We estimated various modifications of the following fixed-effect panel regression models:

$$r_{i,t} = a_0 + B_1 \text{Polit_risk}_{i,t} + B_2 \text{QI}_{i,t} + B_3 \text{Dem}_{i,t} + B_4 \text{Gov}_{i,t} + B_j X_t + e_{i,t} \quad (2)$$

where $r_{i,t}$ is the carry trade return for country i at time t , a_0 is the intercept, Polit_risk is the political risk score, QI_i , Con_i , Dem_i , and Gov_i stand for the four political risk subgroups (*Quality of Institutions*, *Conflict external/internal*, *Democratic Tendencies*, and *Government Actions*), X_t refers to the set of the abovementioned currency-specific controls and $e_{i,t}$ is the disturbance term.

4. Empirical evidence

This section explores the role of political risk in explaining individual currency carry trades. Panel A of Table 1 shows that, in the full sample, individual carry trade returns are high when political risk is high (the score is low), suggesting a conventional risk-return relationship. The aggregate political risk measure is uniformly statistically significant at the 1% level in all of the model specifications. Although, Bachman (1992) suggests that political regime change in developed countries increases the political risks contributing to the forward bias, we find no evidence of a composite political risk effect in developed economies. Conversely, results indicate a significant impact of political risk on currency carry trades in the subsample of emerging countries. Accordingly, studies like Erb et al. (1996) and Dimic et al. (2015), also document the increasing importance of political risk for the financial markets of emerging economies.

Next, we investigated the provenance of the aforementioned political risk effect. Panel B of Table 1, suggests that the results primarily originate in the subgroups of government actions and, to a lesser degree, quality of institutions. Specifically, carry trade returns are high in countries where there is a risk of the government being unable to implement an announced program, and where there is socioeconomic pressure on government actions, and also in countries with legal systems characterized by low levels of impartiality, of institutional strength, and with low quality bureaucratic processes. In

¹ See Dimic et al. (2015) and tables therein for more information on political risk, its components and subgroups.

² We also controlled for traditional risk proxies, e.g., market risk (CRSP value-weighted index), market uncertainty (VIX), and for changes of GDP growth and inflation. The main results were unchanged.

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