Comments on "Understanding the Forward Premium Puzzle" Burnside, Eichenbaum, Rebelo

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A Fine Paper

Continuation of (mostly theoretical) micro-structural approaches to international finance.

Among the Predecessors on UIP:

- Bachetta and van Wincoop

- Mark and Wu

3 Approaches to Heterogeneity in FX

1. **Different Information Sets**

    • Ex: Order Flow (Popular in Micro-Structure)

2. **Different Weights/Models**

    • Ex: Learning with Different Priors

3. **Different Types of Agents** (this model)

    • Ex: Noise Traders/Rational Inattention

    • Ex: Chartists/Fundamentalists (Frankel-Froot; survey evidence from Chinn, Taylor & co-authors)

Information sets seem very different

- Much evidence starting with Evans/Lyons

Different Agent Types also plausible

- But surveys indicate types vary *by horizon* (short-term technical analysis, fundamentals for longer)

More generally, this model doesn't pass sniff test of plausibility … at first

Appealing Features of the Model

- Don't need/want an risk premium

- Don't need/want (very) predictable exchange rates

  o Don't need/want *much* information for "smart money" traders

Stylized Facts We'd Like to Explain ... that this model explains

- Negative slope coefficient (in regression of exchange rate changes on forward premium): UIP works badly

- UIP works better for high-inflation countries (Bansal-Dahlquist)

Stylized Facts We'd Like to Explain ... that this model *could* explain

- UIP works better at coarse horizons (Flood-Taylor)

- Excess returns are strongly linked to expectational errors (Frankel-Froot; Bachetta-Mertens-van Wincoop)

  o Salt water spreads inland ...

Stylized Facts We'd Like to Explain … that this model can't explain (at least not yet)

- Most traders net out within 10 minutes (Lyons), but UIP deviations persist long periods at long horizons

- UIP only for high-interest OECD (Bansal-Dahlquist)

- UIP appears often. Why? Shouldn't smart money focus on deep markets? Admati-Pfleiderer: it can hide there!

- UIP works better in fixes than floats

- *Something's Special about FX (but not e.g., stocks)!*

Theoretical Question 1

- The dumb guys here lose money; why don't they leave?

    o No finite horizon problem (standard in noise trader models)

    o Dumb traders don't "create their own space" as in DeLong et al

    o Here: they just don't lose much (lame!)

    o Dumb guys *could* act like rational dumb guys

Theoretical Question 2

- Why do the dumb guys act as they do?

  o Posited informal idea: If exports rise, demand for hedging rises

    - Implausible! Few agents engaged in real trade

    - Most financial trade is speculative, not hedging

Critical: Need dumb guys to sell forward when public information implies currency expected to depreciate

- *If UIP held,* then no trade at all is rational for risk-neutral

- *Actual Pattern of UIP deviations* implies that currency typically *appreciates* when markets indicate expected depreciation (positive interest differential); easy rule of thumb is "buy spot," almost *opposite* of posited behavior

A More Appealing Approach

- Model the dumb guys as rational (Ironic!)

  o Ex: Bachetta and van Wincoop; costs of collecting/processing information leads to 'rational inattention'

  o Alternatively have the noise traders both create risk and help to bear it (Jeanne-Rose)

Some More Auxiliary Hypotheses Please

- Need more testable/rejectable hypotheses as checks, if this model is to be taken seriously

Still, A Step Forward on a Tough Problem

- Nice Model

- Fits many stylized facts well

- Good preclusion of potential issues

- Good to know that Irrationality is Popular in the Heartland

Technical Question

- Here, derive forward rates with exogenous spot process.
  - Usually, exog interest differential and CIP implies forward rate; UIP focus is on spot process
    - Forward activity small
  - Anything of substance here? Does CIP hold?
  - Does size of forward premium affect UIP deviation in theory or practice?