

# Random Walk Expectations and the Forward Discount Puzzle

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Two well-known, but seemingly contradictory, features of exchange rates are that they are close to a random walk (RW) and at the same time exchange rate changes are predictable by interest rate differentials. The RW hypothesis received strong support from the work of Richard A. Meese and Kenneth Rogoff (1983) who were the first to show that macro models of exchange rate determination could not beat the RW in predicting exchange rates. On the other hand, Eugene F. Fama (1984) showed that high interest rate currencies tend to appreciate subsequently. This is known as the forward discount puzzle and stands in contrast to Uncovered Interest Parity (UIP), which says that a positive interest differential should lead to an expected depreciation of equal magnitude.

The RW hypothesis and the forward discount puzzle are not as contradictory as they seem since the predictability of exchange rate changes by interest differentials is limited. For example, Fama (1984) reports an average  $R^2$  of 0.01 when regressing monthly exchange rate changes on beginning-of-period interest differentials. In this paper, we investigate whether these two features of the data may be related. In particular, we ask whether the predictability of exchange rates by interest differentials naturally results when participants in the foreign exchange (FX) market adopt RW expectations.

RW expectations in the FX market are quite common, in particular when using carry trade strategies, i.e., investing in high interest rate currencies and neglecting potential exchange rate movements. These strategies typically deliver

significant excess returns (see Carlos Bazan et al. 2006; Craig Burnside et al. 2006; or Miguel Villanueva forthcoming for recent evidence). Moreover, many observers argue that recent movements among major currencies are actually caused by carry trade strategies. The adoption of RW expectations may also be rational. Welfare gains that can be achieved from full information processing are likely to be small because the  $R^2$  from exchange rate predictability regressions is so small. This needs to be weighed against the cost of full information processing.

It is sometimes argued informally that purchases of high interest rate currencies should lead to their appreciation. If correct, that would imply that trade based on RW expectations could lead to the observed predictability of exchange rate changes by interest rates. We show that this simple intuition is misleading, however. With frequent trading based on RW expectations, we find that high interest rate currencies depreciate much more than what UIP would predict. When agents make infrequent FX portfolio decisions, however, we find that high interest rate currencies do appreciate when investors adopt RW expectations. Thus, RW expectations can explain the forward premium puzzle, but only if FX portfolio positions are revised infrequently.

This paper is closely related to Bacchetta and van Wincoop (2006). In that paper, we argue that less than 1 percent of global FX positions are actively managed. We therefore consider a model in which agents make infrequent FX portfolio decisions. We show that the welfare cost from making infrequent portfolio decisions is very small, especially in comparison with observed FX management fees. We also show that when agents make infrequent decisions about FX positions, high interest rate currencies tend to appreciate. This is particularly the case when agents process only partial information. In this paper, we consider the particular case of partial information processing whereby agents simply adopt RW expectations. Apart from being realistic, the simple case of RW expectations also has the advantage that it leads to some precise analytical results.

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The remainder of the paper is organized as follows. In Section I, we examine the impact of frequent portfolio adjustment based on random walk expectations. In Section II, we present the model with infrequent decision making when the forward discount (interest differential) follows an autoregressive process. We particularly focus on an  $AR(1)$  process, for which precise analytical results can be obtained. In Section IV, we take the general form of the model to the data, and show that it can account for the forward discount puzzle only when investors make infrequent portfolio decisions. Section V concludes. Some technical details can be found in a Technical Appendix that is available on request.

**I. Frequent Decision Making**

In this section, we present a simple model assuming that all investors make portfolio decisions each period and expect the exchange rate to follow an RW. We focus on the implications for the Fama regression  $s_{t+1} - s_t = \beta_0 + \beta fd_t + e_t$ . Here,  $s_t = \ln S_t$  is the log exchange rate, and  $fd_t$  is the forward discount. We show that frequent FX trading implies a positive and large Fama regression coefficient  $\beta$ , i.e., a bias opposite to the empirical evidence.

There are two countries: home and foreign. There is a single good with the same price in both countries, so that investors in each country face the same real return and make the same portfolio decisions. Agents can invest in nominal bonds of both countries. Asset returns, measured in the home currency, are  $e^i_t$  and  $e^{i^*_t + s_{t+1} - s_t}$  for home and foreign bonds, respectively. Here,  $i_t$  and  $i^*_t$  are the log of one plus the nominal interest rates in home and foreign currencies. The forward discount is then  $fd_t = i_t - i^*_t$ . Real returns are assumed to be constant, which, for simplicity, we normalize at 0, as a result of a risk-free technology that investors also have access to.

There are overlapping generations of investors who live for two periods. When born, they receive an endowment of the good that is worth one unit of the home currency, invest it, and consume the return the next period. Agents born at time  $t$  maximize expected period  $t + 1$  utility  $E_t C_{t+1}^{-\gamma} / (1 - \gamma)$  subject to  $C_{t+1} = 1 + b_t(e^{i_{t+1}} - 1)$ , where  $b_t$  is the investment in foreign bonds are measured in terms of home currency, and  $q_{t+1} = s_{t+1} - s_t + i^*_t - i_t$  is the log excess return

on foreign bonds from  $t$  to  $t + 1$ . The solution of this optimization is

$$(1) \quad b_t = \bar{b} + \frac{E_t q_{t+1}}{\gamma \sigma^2},$$

where  $\bar{b}$  is a constant that depends on second moments, and  $\sigma^2 = var_t(q_{t+1})$  will be constant over time in equilibrium. Since we adopt a two-country model we assume that the steady-state supply of foreign bonds is equal to half of total steady-state financial wealth. Assuming that the foreign bond supply is fixed in terms of the foreign currency, the log-linearized supply of foreign bonds measured in the home currency is  $0.5s_t$ . Here, both the supply and  $s_t$  are in deviation from their steady state. The foreign bond market equilibrium condition in deviation from steady state then becomes

$$(2) \quad \frac{E_t q_{t+1}}{\gamma \sigma^2} = 0.5s_t.$$

The assumption of RW expectations implies that  $E_t s_{t+1} = s_t$ , so that  $E_t q_{t+1} = -fd_t$ . The one-period change in the equilibrium exchange rate is then

$$(3) \quad s_{t+1} - s_t = -\frac{2}{\gamma \sigma^2}(fd_{t+1} - fd_t),$$

so that the Fama regression coefficient is:

$$\beta = \frac{cov(s_{t+1} - s_t, fd_t)}{var(fd_t)} = -\frac{2}{\gamma \sigma^2}(\rho - 1),$$

where  $\rho$  is the first-order autocorrelation coefficient of the forward discount. Since  $\rho < 1$  if  $fd_t$  is stationary,  $\beta$  is positive so that the Fama regression has the wrong sign. The exchange rate is expected to depreciate, rather than appreciate as in the data, when the forward discount rises. Moreover, the Fama coefficient tends to be substantially larger than one. For quarterly data discussed in Section III,  $\sigma$  and  $\rho$  are about 0.05 and 0.8. Even when we set  $\gamma = 10$ , the implied Fama coefficient is  $\beta = 16$ .

The intuition for the wrong sign of the Fama coefficient comes from the stationarity of the forward discount or interest rate differential. Stationarity implies that when the interest differential  $i - i^*$  is high today, on average it tends

to fall the next period. This reduces demand for the home currency next period, leading to its depreciation. High interest rate currencies therefore tend to depreciate.

**II. Infrequent Portfolio Adjustment**

In this section, we present the model where investors make infrequent portfolio decisions. There are still overlapping generations of agents, but they now live  $T + 1$  periods and make only one portfolio decision for  $T$  periods. Otherwise, the model is the same as in Section I, which corresponds to the case  $T = 1$ . The crucial aspect is that portfolio holdings do not all respond to current information on interest rates. At any point in time there are  $T$  generations of investors, only one of which makes a new portfolio decision. Information is therefore transmitted gradually into portfolio decisions and thus into prices. This corresponds to the fact that most FX positions are not actively managed.

Investors born at time  $t$  invest  $b_t$  in foreign bonds, measured in the home currency. They hold this foreign bond investment constant for  $T$  periods. Any positive or negative return on wealth leads holdings of the home bond or the risk-free technology to adjust accordingly. An agent born at time  $t$ , starting with a wealth of one, accumulates a real wealth of  $1 + b_t \sum_{i=1}^T (e^{q_{t+i}} - 1)$  at  $t + T$ , which is consumed at that time. End-of-life utility is the same as before. The optimal portfolio of investors born at time  $t$  is then

$$(4) \quad b_t = \bar{b} + \frac{E_t q_{t,t+T}}{\gamma \text{var}_t(q_{t,t+T})},$$

where  $q_{t,t+T} = q_{t+1} + \dots + q_{t+T}$  is the cumulative excess return on foreign bonds from  $t$  to  $t + T$ .

The foreign bond market equilibrium clearing condition (in deviation from steady state) then becomes

$$(5) \quad \sum_{j=1}^T \frac{1}{T} \frac{E_{t-j+1} q_{t-j+1,t-j+1+T}}{\gamma \sigma_T^2} = 0.5 s_t,$$

where  $\sigma_T^2 = \text{var}_t(q_{t,t+T})$  is constant over time in equilibrium. This equates the average holdings of the foreign bond over the  $T$  generations alive to the per capita foreign bond supply.

Now adopt RW expectations, so that  $E_t q_{t,t+T} = - \sum_{k=1}^T E_t f d_{t+k-1}$ . Since investors have a multi-period horizon, we need to make an assumption about the statistical process of the forward discount. We assume that it follows an  $AR(p)$  process. This implies parameters  $\alpha_i$  such that  $\sum_{k=1}^T E_t f d_{t+k-1} = \sum_{i=1}^p \alpha_i f d_{t+1-i}$ . The one-period change in the equilibrium exchange rate is

$$(6) \quad s_{t+1} - s_t = - \frac{2}{\gamma T \sigma_T^2} \times \sum_{i=1}^p \alpha_i (f d_{t-i+2} - f d_{t-i+2-T}).$$

The Fama regression of  $s_{t+1} - s_t$  on  $f d_t$  then yields the coefficient

$$(7) \quad \beta = - \frac{2}{\gamma T \sigma_T^2} \sum_{i=1}^p \alpha_i (\rho_{i-2} - \rho_{T+i-2}),$$

where  $\rho_j = \text{corr}(f d_t, f d_{t-j})$  and  $\rho_{-j} = \rho_j$ . It is clear that when  $T$  gets large,  $\rho_{T+i-2}$  tends toward zero when the forward discount is a stationary process. Therefore, the Fama coefficient becomes negative for  $T$  large enough, assuming positive autocorrelations and positive  $\alpha_i$ .

A nice illustration of this is the special case of an  $AR(1)$  process. Then  $p = 1$  and  $\alpha_1 = 1 + \rho + \dots + \rho^{T-1}$ , where  $\rho$  is the autoregressive coefficient. The Fama regression coefficient becomes

$$(8) \quad \beta = - \frac{2}{\gamma T \sigma_T^2} \rho (1 - \rho^{T-2}) \sum_{i=1}^T \rho^{i-1}.$$

The coefficient is positive for  $T = 1$  (as shown in the previous section), zero for  $T = 2$ , and then turns negative for  $T > 2$ . The model can therefore account for the negative Fama coefficient in the data as long as agents make infrequent portfolio decisions. This is a result of delayed overshooting. When the foreign interest rate falls (and therefore the forward discount rises), investors shift from foreign to home bonds and the home currency appreciates. This continues for  $T$  periods as new generations continue to adjust their portfolio from foreign to home bonds due to the lower foreign interest rate. Only after  $T$  periods is this process reversed. Investors start buying foreign bonds again and the home currency depreciates. The reason is that the foreign interest rate has increased by then, and investors

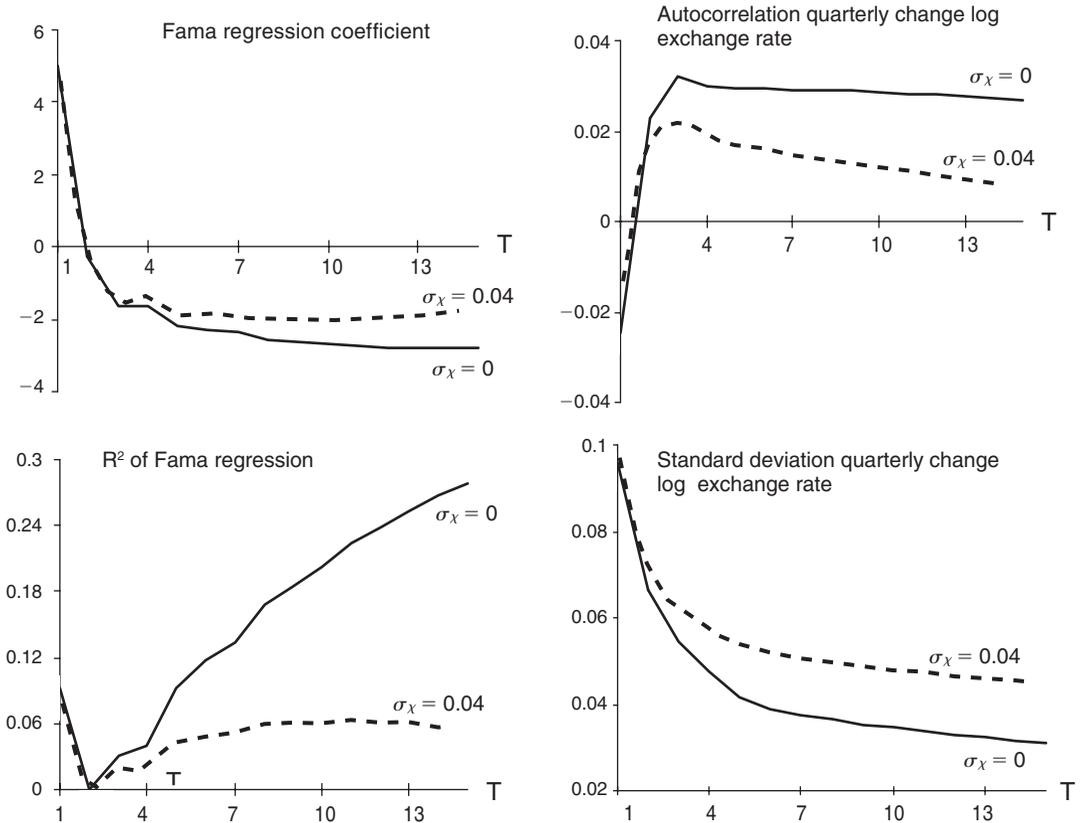


FIGURE 1. FAMA REGRESSION AND EXCHANGE RATE MOMENTS

who sold foreign bonds  $T$  periods earlier are due to make a new portfolio decision. The continued appreciation for  $T$  periods, after the increase in the forward discount, gives rise to a negative Fama coefficient.

When  $T$  approaches infinity the Fama coefficient goes to zero. This implies that there is an intermediate value of  $T$  for which the Fama coefficient is most negative. When  $T$  is large the exchange rate response to interest rate shocks is small since only a small fraction of agents makes active portfolio decisions at any point in time. Both the initial appreciation and the subsequent appreciation for  $T$  periods are then small.

### III. Quantitative Illustration

We now quantify the Fama coefficient implied by the model above by estimating an autoregressive process for the forward discount. Moreover,

we extend the model to allow for noise or liquidity traders. In the model, exchange rates are completely driven by interest rate shocks. It is well-known though that interest rate shocks, or other observed macro fundamentals, account for only a small fraction of exchange rate volatility in the data. Therefore, instead of a per capita foreign bond supply of 0.5 (in foreign currency), we assume that it is  $0.5X_t$ , where  $X_t$  represents shocks to net demand or supply associated with liquidity or noise traders. We assume that  $x_t = \ln(X_t)$  follows a random walk with innovation  $\varepsilon_t^x$  at time  $t$  that is  $N(0, \sigma_x^2)$  distributed. The only change to the expression (6) for  $s_{t+1} - s_t$  is that  $\varepsilon_{t+1}^x$  is added on the right-hand side. The expression for the Fama coefficient is unchanged. But the noise trade does affect the conditional variance  $\sigma_T^2$  of the excess return that shows up in the expression for the Fama coefficient. Moreover, since the noise shocks are uncorrelated with

interest rate shocks, they lower the  $R^2$  of the Fama regression.

We estimate autoregressive processes for the forward discount using monthly data on three-month interest rates for six currencies for the period December 1978 to December 2005. The currencies are the US dollar, Deutsche mark-euro, British pound, Japanese yen, Canadian dollar, and Swiss franc. The forward discount is equal to the US interest rate minus the interest rate on one of the other currencies. Interest rates are three-month rates quoted in the London Euromarket and obtained from Datastream. We use the simple average of the autoregressive coefficients and standard deviations of innovations estimated for the five forward discount series. While we have computed results for  $p$  ranging from 1 to 5, due to space considerations we report results only for an  $AR(3)$  process. Results are similar for other values of  $p$ .

We set  $\gamma = 10$  (see Bacchetta and van Wincoop 2006 for a discussion). Figure 1 reports results for the Fama regression coefficient, the  $R^2$  of the Fama regression, the autocorrelation of quarterly log exchange rate changes, and the standard deviation of the quarterly log exchange rate change, with  $T$  ranging from 1 to 15. Results are reported for  $\sigma_x = 0$  (previous section) and  $\sigma_x = 0.04$ . Results can be compared to the data, which yield an average Fama coefficient of  $-1.6$ , average  $R^2$  of  $0.04$ , average first-order autocorrelation of  $0.055$ , and average quarterly standard deviation of  $5.4$  percent.

The model does well in accounting for the negative Fama coefficient. For  $\sigma_x = 0.04$ , the Fama coefficient remains close to  $-2$  for  $T \geq 3$ . For  $\sigma_x = 0$  it is even slightly more negative. When  $\sigma_x = 0.04$ , the  $R^2$  of the Fama regression is always less than  $0.06$  and less than  $0.02$  for  $T \leq 4$ . For  $\sigma_x = 0$ , it is less than  $0.04$  for  $T \leq 4$  but gets much larger for higher values of  $T$ . The autocorrelation of quarterly changes in exchange rates is also small, less than  $0.03$  for both values of  $\sigma_x$ . These results indicate that the exchange rate behaves similarly to a RW, with future exchange rate changes hard to predict by the forward discount and past exchange rate changes. The standard deviation of the quarterly log change in the exchange rate drops as  $T$  rises, which weakens the portfolio response to interest rates. It becomes broadly consistent with the data for  $T \geq 4$ .

To summarize, when  $T > 1$  (infrequent portfolio decision making), the model can account for a wide range of evidence about exchange rates, including the negative Fama coefficient as well as the near-RW behavior of the exchange rate. For example, when  $T = 4$ , the Fama regression coefficients are  $-1.6$  and  $-1.4$  for  $\sigma_x$  equal to, respectively,  $0$  and  $0.04$ . The  $R^2$  is respectively  $0.04$  and  $0.02$ . The autocorrelations of quarterly exchange rate changes are  $0.03$  and  $0.02$ , respectively, and the standard deviations of quarterly exchange rate changes are  $4.8$  percent and  $5.8$  percent. These are all close to the data.

#### IV. Conclusion

We have shown that even when the exchange rate is close to a RW, and investors sensibly adopt RW expectations, exchange rate changes can be predicted negatively by the forward discount with a coefficient that is in line with the Fama or forward discount puzzle. This happens when investors make infrequent decisions about FX positions.

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