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: Chartist/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?
  - 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.
  
  o Usually, exog interest differential and CIP implies forward rate; UIP focus is on spot process
    ▪ Forward activity small
  
  o Anything of substance here? Does CIP hold?
  
  o Does size of forward premium affect UIP deviation in theory or practice?