Revisiting the Forward – Spot Relation: A Nonparametric Approach

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This study examines the statistical relationship between the spot and the forward rates for £/DM over the May 1992 British General Election and September 1992 ERM devaluation. In contrast to previous studies, this association is measured by the estimation of a non-parametric measure of linear association. This nonparametric approach has the advantage of resolving several important problems faced by previous studies, namely the uncertainty regarding the existence of cointegration between the two rates, peso problems and the frequently reported parameter instability of the relationship. We employ the recently developed nonparametric long-run correlation coefficient, which is equivalent to the Bartlett kernel spectral estimator of the complex coherency at frequency zero, and which allows for the measurement of the intensity of correlation. The results, both recursive and rolling, show that the predictive ability of the forward rate increased markedly when the market participants viewed the stated parity as unsustainable.

Keywords: Spot, Forward, Peso Problem, Long-Run Correlation Coefficient.

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