

## CURRENCY RISK PREMIUMS: THEORY AND EVIDENCE

**John A. Carlson, Carol L. Osler**

**carlson@mgmt.purdue.edu**

Economists have long been perplexed by the negative relationship between short-run exchange-rate changes and interest differentials, known as the “forward premium puzzle.” This paper develops an exchange-rate model that accounts for all of the notable empirical regularities associated with this puzzle. The model focuses on short-run exchange-rate dynamics, consistent with the short-run focus of the puzzle. This short-run focus, together with recent evidence on currency market microstructure, explains why the model incorporates a central role for flow demand and supply. In modeling speculative agents we note that, because of agency problems, short-term traders are encouraged to focus on profits rather than consumption.

The model’s clear analytic solutions show that risk premiums can be time varying and strongly negatively related to interest differentials. Simulations show that the volatility of exchange-rate returns exceeds the volatility of both interest differentials and forward premiums, and that exchange-rate persistence is quite low while that of expected excess returns is fairly high. Regression estimates using quarterly data for five currencies provide strong support for the model, suggesting that currency microstructure may have macroeconomic relevance.

Corresponding author: John A. Carlson  
Department of Economics  
School of Management  
Purdue University  
West Lafayette, IN 47906

Telephone: 765-494-4450

Fax: 765-494-9658

Email: carlson@mgmt.purdue.edu

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