The Returns to Currency Speculation
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Abstract

A classic puzzle associated with the failure of uncovered interest parity is that when currencies are at a forward premium they tend to depreciate. We refer to this anomaly as the forward premiumdepreciation puzzle. We document the returns to currency speculation strategies that exploit this anomaly. The first strategy, known as the carry trade, is widely used by practitioners. This strategy involves selling currencies that are at a forward premium and buying those that are at a forward discount. The second strategy relies on a particular regression to forecast the payoff to selling currencies forward. We show that these strategies yield high Sharpe ratios which are not a compensation for risk. However, these Sharpe ratios do not represent unexploited profit opportunities. In the presence of microstructure frictions, spot and forward exchange rates move against traders as they increase their positions. The resulting `price pressure' drives a wedge between average and marginal Sharpe ratios. We argue that marginal Sharpe ratios are zero even though average Sharpe ratios are positive. We display a simple microstructure model that simultaneously rationalizes `price pressure' and the forward premiumdepreciation puzzle. The central feature of this model is that market makers face an adverse selection problem that is less severe when, based on public information, the currency is expected to appreciate.