

3.6 Covered Interest Rate Parity

The spot interest rate in country X for maturities of 3 months is 3.1% (APR semi-annual compounding). The spot interest rate in country Y for maturities of 3 months is 2.6% (APR semi-annual compounding). The currency in country X is XCU, while that in country Y is YCU. The spot currency exchange rate is 0.89 XCU per YCU. Estimate the forward currency exchange rate for 3 months ahead.

SOLUTION

Local df for 3 months = 0.9923

Foreign df for 3 months = 0.9936

$$\frac{0.89}{0.9923} = \frac{F}{0.9936}.$$

Solving for F (forward exchange rate),

$$F = 0.8911.$$