Commodity Trade and the Carry Trade: A Tale of Two Countries

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Persistent differences in interest rates across countries account for much of the profitability of currency carry trade strategies. The high-interest rate "investment" currencies tend to be "commodity currencies," while low interest rate "funding" currencies tend to belong to countries that export finished goods and import most of their commodities. We develop a general equilibrium model of international trade and currency pricing in which countries have an advantage in producing either basic input goods or final consumable goods. The model's primary mechanism is that productivity shocks to final good producers are more important for global risk, and that these producer countries are forced to bear this risk, which in turn gives rise to differences in riskiness across currencies, and profitable carry trade strategies.

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