A Quantity-Driven Theory of Term Premia and Exchange Rates

In this paper, the authors develop a model in which specialized bond investors must absorb shocks to the supply and demand for long-term bonds in two currencies. Since long-term bonds and foreign exchange are both exposed to unexpected movements in short-term interest rates, a shift in the supply of long-term bonds in one currency influences the foreign exchange rate between the two currencies, as well as bond term premia in both currencies. Their model matches several important empirical patterns, including the co-movement between exchange rates and term premia, as well as the finding that central banks' quantitative easing policies impact exchange rates. An extension of their model sheds light on the persistent deviations from covered interest rate parity that have emerged since 2008.

described herein, and is only current as of the date indicated. There is no assurance that such events or targets will be achieved, and may be significantly different from that shown here. The information in this document, including statements concerning financial market trends, is based on current market conditions, which will fluctuate and may be superseded by subsequent market events or for other reasons.