F A C T O R / S T Y L E   I N V E S T I N G

Carry Trades and Currency Crashes

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This paper provides evidence of a strong link between currency carry and currency crash risk: investing in high-interest-rate currencies while borrowing in low-interest-rate currencies delivers negatively skewed returns. We document that speculators invest in highIcarry currencies and argue that currency crashes are linked to the sudden unwinding of these carry trades.

Consistent with models in which the erosion of capital increases insurance premia, we find that the price of protecting against a crash in the aftermath of one increases despite the fact that a subsequent crash is less likely. Further, we document that currency crashes are positively correlated with increases in implied stock market volatility VIX and the TED spread, indicators of funding illiquidity, among other things. This could be the outcome of a setting in which higher volatility leads to lower available speculator capital due to higher margins and capital requirements, inducing traders to cut back on their carry trade activities.

Moreover, we find that a higher VIX predicts higher carry returns going forward and that controlling for this effect reduces the FX return predictability of interest rates, that is, it helps resolve the uncovered interest-rate parity (UIP) violation. Finally, our finding that currencies with similar interest rates move with one another, controlling for other effects, further suggests that carry trades affects exchange rate movements.

Overall, our results are consistent with the view that macroeconomic fundamentals determine which currencies have high and low interest rates and the longIrun currency levels, while illiquidity and capital immobility lead to shortIrun currency underreaction to changes in fundamentals and occasional currency crashes due to liquidity crises.

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