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COVERED INTEREST PARITY: EVIDENCE FROM RUSSIAN MONEY MARKET

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Policy Brief

A. Exposition of the policy problems under investigation

The recent financial crisis attracted the attention of researchers and central banks to the effects of money and financial market structure on transmission mechanism. The Central Bank usually controls overnight interbank rates by guiding the market participants' expectations through daily open market operations. When the overnight rate is set at a desirable level in the normal market situation, it is transmitted to other interest rates through arbitrage. This transmission mechanism is deteriorated during financial crises because banks become limited by liquidity constraints or face substantial counterparty risks (Saito and Shiratsuka 2001). Deviations from the covered interest parity may indicate weakness of the transmission mechanism.

B. Critical review of the existing policies

Traditionally, monetary authorities used offered rates as indicators of money market conditions. However, as it turned out during the recent financial crisis, offered rates may be confusing even if related to the most developed markets. The dollar LIBOR is a good example. The Central Bank of Russia is one of the few national monetary authorities focusing on actual money market rates. However, practitioners still prefer offered rates as MosPrime. Additionally, both the Central Bank and analysts focus on the shortest interbank credit rates.

C. Overview of alternative policy changes

Both, choice between actual and offered rates as major indicators of money market condition, and attention to the term structure of the money market may affect monetary policy.

D. Policy recommendations arising from the research

We found that evidence from actual and offered rates is qualitatively the same. We may interpret this finding as a sign that offered rates do not mislead decision makers after all.

However, credit risk and turbulence affect actual rates more strongly, that is, they impact money market lending conditions more severely compared to evidence from offered rates. It is useful to account for this when implementing monetary policy.

The term structure of interbank rates matters. Longer term credits are much more dependent on risk premium variance.

E. Directions for further policy analysis

First, there is the turbulence puzzle. We obtain a paradoxical result that turbulence decreases deviations from the parity, at least when combined with risk premium. It is important for policy-making to understand why this happens.

Second, we predict and find an interesting channel of policy rate impact on money market rates. A higher policy rate attracts more risky borrowers to the money market. Careful testing of this effect can be a good research question. Taking this effect into account may help improve monetary policy.