

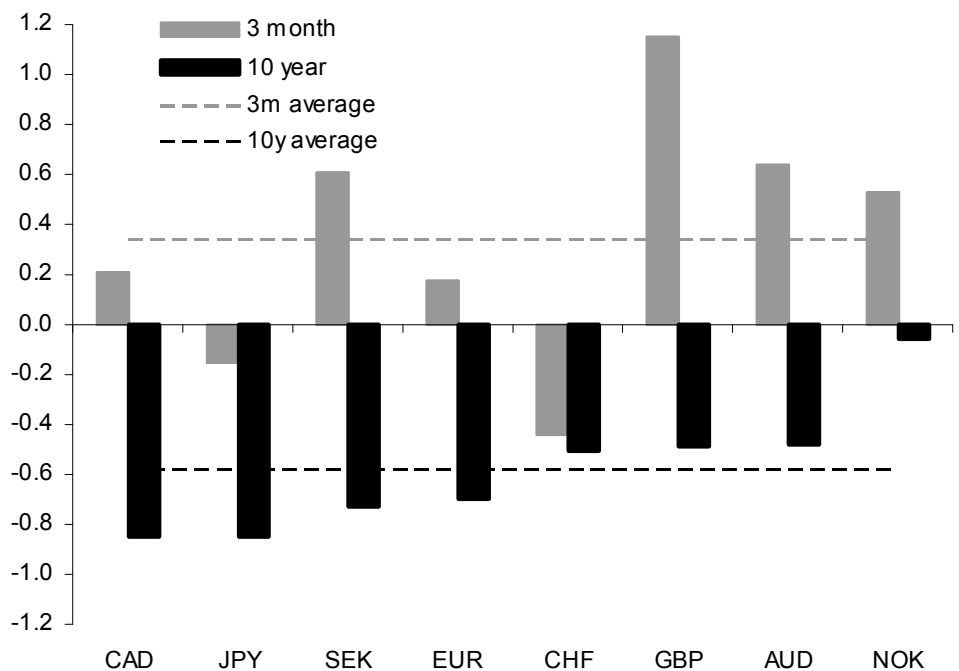
# Is the Dollar Reflecting Inflation Risk?

*Three decades of falling inflation expectations in the G10 have resulted in a positive correlation between inflation surprises and short-term currency appreciation. But how might G10 FX perform if long-term inflation expectations were to rise again? To answer this question we examine the link between bond risk premia and foreign exchange. Notably, long-run FX performance is more strongly linked to 10y rate differentials than short-term returns are to 3m differentials, suggesting that inflation does matter for currencies in the grand scheme. We also find that the dollar fell in the late-70s as inflation expectations rose, and only rallied when Fed hikes resulted in a rising bond risk premium as the markets felt inflation had been tamed. In recent years, bond risk premia have been driven mainly by growth expectations. FX performance is more closely linked with risk premia, in which inflation and growth are important factors, than nominal long rates alone.*

## Inflation matters: uncovered interest rate parity in the long run

One of the most persistent puzzles in international finance is the failure of uncovered interest rate parity (UIP), otherwise known as “forward rate bias”. The purchasing power parity theory which arises from UIP dictates that interest rate differentials should be perfectly offset by spot depreciation; that is, for every 1% of carry, the FX pair should depreciate by 1%, resulting in a zero total return. In fact, we find that over short horizons (3m), regressions of spot returns on interest rate differentials yield positive coefficients for most G10 USD-crosses. This phenomenon motivates the G10 FX “carry trade” that has delivered steady

**Estimated elasticity of spot returns to interest rate differentials, 1976-2010**



Source: Deutsche Bank. Regressions of spot returns on rate differentials, no constant, at 3m and 10y horizons, respectively. All 3m regressions are insignificant; all 10y beta estimates are significantly less than zero with the exception of NOK. Newey-West standard errors correction for autocorrelation due to overlapping data.