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Efficiency of the Foreign Exchange Market in Mexico 1997-2007:

Covered and Uncovered Interest Rate Parities, Risk Premium and Rational Expectations



Abstract

In this research a market exchange rate evaluation is undertaken between the US Dollar and the Mexican Peso, with particular focus on forward contracts. The results conclude that there are elements with which to consider the existence of inefficiencies related not only the presence of systematic errors in the expectation estimates made by investors but also to the influence of a risk premium that moves with time. Through the application of static and dynamic econometric techniques, an assessment is undertaken of the exchange rate market in the period November 1997 to June 2007 in relation to several forward perspectives (1, 3, 6, 12 and 24 months). Through the analysis of interest rates, forward and spot exchange rates and devaluation expectations, the performance of the Covered and Uncovered Interest Rate Parities is verified. The results indicate the failure of both hypotheses, suggesting the existence of inefficiency in the Mexican exchange rate market under analysis. With the objective of analyzing the causes of this inefficiency, a detailed assessment is carried out in order to determine the influence of a risk premium that varies over time in the purchase of assets in pesos and the failure of investors to incorporate available information into their expectations.