What Factors Caused the Increasing Currency Hedging Cost?

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Abstract

The increasing currency hedging costs have been highlighted in recent years. The hedging costs to cover the US dollar exposures has been increasing at a faster pace than the interest rate differentials, which indicates the violation of covered interest rate parity (CIP). The deviations from CIP have become evident even though there has been no symptom indicating worsened creditworthiness of global financial institutions as well as the associated liquidity tightness observed during the past crisis period.

This study employs two empirical methodologies to examine the determinants of CIP deviations by focusing on the gap of monetary policy stances across nations and other macroeconomic structural factors. First, historical decomposition analysis is implemented to detect a main factor bringing about the upward trend of the hedging costs in the past few years. Second, panel data analysis is conducted to confirm the relationship between CIP deviations and macroeconomic structural factors.

Results show that the cost of hedging exposure to foreign currencies, particularly the US dollar, might arise from the increased outward securities investments promoted by the difference of monetary policy stances across countries. This study also reveals that macroeconomic structural factors were related to the increase in hedging costs. The significant increase in the price of hedges for yen investors might be driven by their biased preference toward the US dollar securities investments.