16. INTREST RATE PARITY

Q:1 Explain the Interest Parity Rate Theory?

(A) Interest Rate Parity (IRP) :- Interest Rate Parity is a theory in which interest rate is different between two Countries is equal to difference between Forward Exchange Rate and Spot Exchange Rate.
The Interest Rate Parity shows the relationship between Domestic interest rates and Foreign Interest Rates and the expected appreciation of Domestic Currency.
IRP Plays an important role in FOREX market which governs the relationship between Interest Rates and Currency Exchange Rates.

(B) IRP-Theory :- IRP is a concept of No-Arbitrage in the FOREX market. It means Simultaneous purchase and Sale of Foreign Currency i.e buying a currency in one market and selling it in another market to earn Profits due to Change in Exchange Rates.
Here investors Cannot Lock in Current Exchange Rate in one Currency for Lower Price and then Purchase another Currency from a Country offering a higher interest rates.

(C) FORMULA :-

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$$IRP = F_0 = S_0 \times \left(\frac{1+i_c}{1+i_b}\right)$$

F_0 = Forward Rate
S_0 = Spot Rate
i_c = Interest rate in Country c
i_b = Interest rate in country b

Forward Exchange Rates means exchange rates at a Future Point in time and it is opposed to spot Exchange Rates. The difference between the forward Rate and spot rate is known as Swap Rate.
If this difference is Positive, it is known as a Forward Premium and Negative difference is known as a Forward Discount.
A Currency with Lower interest rates will trade at a Forward Premium in relation to a Currency with a higher interest rate.
Example :- The U.S. Dollar mostly trades at Forward Premium against Canadian dollar.

Types of IRP

1. Covered IRP
2. Uncovered IRP

1. **Covered IRP :-** IRP is Covered when the no-arbitrage condition could be satisfied through the use of forward Contract to Protect against Foreign Exchange Risk.

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2. **Uncovered IRP :-** IRP is said to be uncovered when the No-Arbitrage condition could be satisfied without use of forward contracts to protect against future exchange risk.

(D) Implications of IRP :-

1. If domestic interest rates are less than foreign interest rates, foreign currency must trade at forward discount to offset (adjust) any benefit of higher interest rates in foreign country to prevent arbitrage.
2. If domestic rates are more than foreign interest rates, foreign currency must trade at a forward premium to offset (neutralise) any benefit of higher interest rates in domestic currency to prevent arbitrage.
3. If foreign currency does not trade at forward discount then arbitrage opportunity is available for domestic investors to get benefit by investing in the foreign market.
4. If foreign currency does not trade at forward premium then arbitrage opportunity is available for foreign investors. Foreign investors can earn profit by investing in the domestic market.

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