Abstract

Carry trade strategy exploits the deviation of uncovered interest parity (UIP) by borrowing risk free asset in low interest rate currency and invests it in the high interest rate currency. The UIP theory states that the interest rate differential should be equal to the exchange rate changes between two currencies. However, previous researchers have documented the tendency of the high interest currency exchange rate to appreciate instead of depreciating. So this strategy provides benefits of excess exchange rate return beyond the interest rate differential. Since it is dependent on the interest rate differential, the change of interest rate on one currency will affect the carry trade return. Monetary policy rate changes have been proved to have an effect not only on the interest rate but also on the exchange rate. By regressing the change of monetary policy rate on the carry trade return, this paper provides empirical analysis that shows the impact of monetary policy rate changes to the carry trade return from the perspective of a US investor. The result suggests that the funding currency (currency with a low interest rate) monetary policy has a negative impact on the carry trade return. Meanwhile, investors do not react significantly to the change of the target currency (currency with a high interest rate) monetary policy rate.