Risk and Segmentation in Covered-Interest Parity Arbitrage

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Abstract

Prevailing theories of financial intermediation struggle to explain a striking feature of bank-intermediated arbitrages: spreads on these trades exhibit substantial cross-sectional variation in sign and magnitude. We use confidential supervisory data—covering $25 trillion in daily notional exposures on average—to study covered-interest parity (CIP) deviations in currency markets. We uncover three novel forces important for explaining cross-sectional variation in CIP deviations: foreign safe asset scarcity, which makes CIP arbitrage imperfect and risky; market segmentation, with banks specializing in different markets; and concentration of demand. Our findings highlight the presence of risk in ostensibly riskless arbitrage and the importance of segmentation and search frictions in even the most liquid markets.

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