1 INTRODUCTION

In a recent article in this journal Paul Coulbois and Pierre Prissert made some critical remarks about the traditional theory concerning the functioning and the influence of forward exchange markets. On the basis of their analysis they rejected the traditional theory and presented a different motivation for policy measures to be taken by the monetary authorities during periods of (serious) speculative disturbances in the foreign exchange markets. Partly because they formulated their critical remarks in rather positive terms, we want to react on two main lines of thought in their argument:

(a) the explanation of the functioning of the forward exchange market;
(b) the implications of (un)covered transactions for the spot rate, the official reserves and the internal money supply.

We shall deal with these two aspects successively in the sections 2 and 3.

2 THE ARBITRAGE FUNCTION AND THE FORWARD EXCHANGE MARKET

The traditional theory on the functioning of the forward exchange market, which is known as the interest parity theory and which is coined by Coulbois and Prissert as the ‘academic theory’ (1974, p. 285), is rejected by these authors. They propose another theory, the so-called ‘cambist theory,’ which is based on the practical experiences of foreign exchange dealers.

Although the first-mentioned theory is probably sufficiently well-known and has been sketched in broad lines by Coulbois and Prissert, it seems necessary to us to reproduce both theories to be able to give a judgment on the cambist

* Both authors are lecturer in International Economic Relations at the Economic Faculty of the Free University of Amsterdam. They want to thank Mr. William Schep for his helpful comments with regard to the translation into English of the original text.

1 Coulbois and Prissert, 1974, p. 283–308.
theory. For the sake of simplicity, in presenting both theories, we shall assume that there only exists one relevant maturity on the forward exchange market.

2.1 The Simplified Version of the Interest Parity Theory
In his 'Tract on Monetary Reform' Keynes\(^2\) presented his since then well-known explanation of the relation between spot and forward exchange rates. In equilibrium the difference between the forward rate and the spot rate (the deviation), as a percentage of the spot rate, will be equal to the difference between the interest rates on the relevant money markets. One may wonder how such an equilibrium will be reached. The answer is that it will be reached by the actions of interest arbitragers who cover their exchange rate risks and react to the existence of an intrinsic deviation.

An intrinsic deviation (ID) is defined as:

\[
ID = (i - i^*) - \frac{r_f - r_s}{r_s}
\]  

(2.1)
in which \(i\) and \(i^*\) are the interest rates on the home and the foreign money market respectively and \(r_f\) and \(r_s\) the forward and the spot rate of the foreign currency expressed in units of the home currency.

The behaviour of interest arbitragers can be formalized by means of an arbitrage function, which (in the simplified version of the interest parity theory) could be stated in the following way:

\[
E_s = E_s(ID; C) = e_s(i; i^*; r_s; r_f; C)
\]  

(2.2)
in which \(E_s\) stands for the excess supply of the interest arbitragers of forward foreign currency during the relevant period and \(C\) for a parameter, the meaning of which will be stated later on.

As appears from the formulation of the arbitrage function an ID can arise, starting with an equilibrium situation in which the ID is nil, if an autonomous change in the market conditions arises in one or both of the money and/or foreign exchange markets. The interest arbitragers, covering against the potential exchange rate risk, would respond to the existence of such an ID by means of exerting additional demand or supply on the spot and the forward exchange market as well as on the money markets. This additional arbitrage activity will at least last till the ID will be equal to nil. It is evident that the speed of adjustment towards a new equilibrium depends on the degree and quality of the communication between the four relevant markets.

\(^2\) Keynes, 1923, chapter 4.