Exchange Rates and UIP Violations at Short and Long Horizons

Job Market Paper

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Abstract

This paper shows that the much-studied UIP puzzle, the observation that exchange rates do not adjust sufficiently to offset interest rate differentials, is more complicated than commonly understood, as it changes nature with the horizon. I confirm the existing short-run evidence that high interest rate currencies depreciate less than predicted by the interest rate differential, but at longer horizons (3+ years) I document the reverse puzzle: high interest rate currencies depreciate too much. Interestingly, the long-horizon excess depreciation leads exchange rates to converge to the UIP benchmark over the long-run. To address this new puzzle, I propose a novel model, based on the mechanism of bond convenience yields, that can explain the full complexity of UIP violations at both short and long horizons. I also provide direct empirical evidence that supports the mechanism.

JEL Codes: F31, F41, F42, E43, E52, E63

Keywords: Uncovered Interest Rate Parity, Exchange Rates, Open Economy Macroeconomics, Bond Convenience Yield

*Please find the latest version of the paper at http://sites.duke.edu/rosenvalchev/research
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