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Monetary Policy and Long-Horizon Uncovered Interest Parity

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Abstract

Uncovered interest parity (UIP) has been almost universally rejected in studies of exchange rate movements. In contrast to previous studies, which have used short-horizon data, we test UIP using interest rates on longer-maturity bonds for the Group of Seven countries. These long-horizon regressions yield much more support for UIP—all of the coefficients on interest differentials are of the correct sign, and almost all are closer to the UIP value of unity than to zero. We then use a macroeconomic model to explain the differences between the short- and long-horizon results. Regressions run on model-generated data replicate the important regularities in the actual data, including the sharp differences between short- and long-horizon parameters. In the short run, the failure of UIP results from the interaction of stochastic exchange market shocks with endogenous monetary policy reactions. In the long run, in contrast, exchange rate movements are driven

by the “fundamental,” leading to a relationship between interest rates and exchange rates that is more consistent with UIP.

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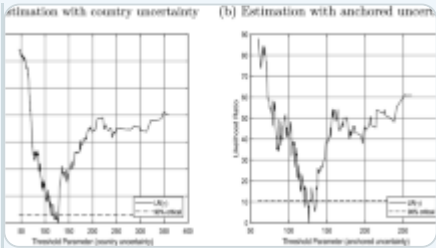
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