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Uncovered interest parity: The long and the short of it

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Highlights

- I examine UIP using annual data spanning two centuries and 17 countries.
- In all cases, bond yields expressed in a common currency are positively related.
- This contrasts with the largely opposite results reported in the literature.
- I attribute this difference to small-sample problems in the data typically used.

Abstract

Uncovered interest rate parity (UIP) is a theoretical relation linking changes in exchange rates and corresponding interest rate differentials. Despite its considerable intellectual appeal, uncovered interest rate parity has very often been found wanting empirically. I reinvestigate this relation using a 17-country panel of historical time series data at its longest—for the US–UK country pair—spanning 217 years. I find results that are largely consistent with theory: over the long term, in most countries, bond yields expressed in common currency bear a positive relationship to one another as UIP predicts. This is in contrast to the very nearly opposite findings reported in much of the literature and now taken as a stylized fact.

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Keywords

Exchange rates; Uncovered interest parity; Forward rate bias; Small sample problems; Financial history

JEL classification

F31; G15; N20

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