

# Accepted Manuscript

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PII: S0261-5606(17)30133-X

DOI: <http://dx.doi.org/10.1016/j.jimonfin.2017.07.012>

Reference: JIMF 1816

To appear in: *Journal of International Money and Finance*



Please cite this article as: A. Ismailov, B. Rossi, Uncertainty and Deviations from Uncovered Interest Rate Parity, *Journal of International Money and Finance* (2017), doi: <http://dx.doi.org/10.1016/j.jimonfin.2017.07.012>

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# Uncertainty and Deviations from Uncovered Interest Rate Parity

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This Draft: March 2017

Abstract: It is well-known that uncovered interest rate parity does not hold empirically, especially at short horizons. But is it really so? We conjecture that uncovered interest rate parity is more likely to hold in low uncertainty environments, relative to high uncertainty ones, since arbitrage opportunity gains become more uncertain in a highly unpredictable environment, thus blurring the relationship between exchange rates and interest rate differentials. In this paper, we first provide a new exchange rate uncertainty index, that measures how unpredictable exchange rates are relative to their historical past. Then we use the new measure of uncertainty to provide empirical evidence that uncovered interest rate parity does hold in five industrialized countries vis-a-vis the US dollar at times when uncertainty is not exceptionally high, and breaks down during periods of high uncertainty.

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J.E.L. Codes: F31, F37, C22, C53. Keywords: Uncertainty, exchange rates, forecasting, uncovered interest rate parity, interest rates.

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