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The Role of Covered Interest Parity in Explaining the Forward Premium Anomaly Within a Nonlinear Panel Framework*

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Abstract

This paper investigates the dynamic properties of uncovered interest parity (UIP) depending on deviations from covered interest parity (CIP) in a nonlinear panel framework. By employing a panel smooth transition regression model, the threshold level of the CIP deviation in which UIP tends to hold is found to be outside the band of inaction where deviations from CIP would fail to be arbitraged away. This paper shows how reversals of UIP observed during the global financial crisis can, to some extent, accounted for by funding liquidity constraints. Simulation experiments also suggest that the data generating process from the nonlinear panel model can produce data consistent with the failure of UIP.

JEL Classification: C13; F31; G15

Keywords: Uncovered interest parity; Covered interest arbitrage; Nonlinearity; Time-varying parameter; Funding liquidity constraints; Band of inaction

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