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## Monetary Policy and Long-Horizon Uncovered Interest Parity

MENZIE D. CHINN and GUY MEREDITH\*

*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. [JEL F21, F31, F41]*

Few propositions are more widely accepted in international economics than that uncovered interest parity (UIP) is at best useless—or at worst perverse—

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\*Menzie D. Chinn is with the LaFollette School and the Department of Economics at the University of Wisconsin. Guy Meredith is with the International Monetary Fund. The authors have benefited from comments by Geert Bekaert, Charles Engel, Jeffrey Frankel, Bob Flood, Peter Isard, Karen Lewis, Bennett McCallum, Andy Rose, and an anonymous referee, as well as seminar participants at the IMF, the U.S. Federal Reserve Board, the Bank for International Settlements, the Federal Reserve Banks of New York and Chicago, the National Bureau of Economic Research International Finance and Macro 2001 Winter meetings, and other venues. The authors are responsible for all remaining errors. We are grateful to Geert Bekaert, Hali Edison, and Gabriele Galati for providing data, and to Advin Pagtakhan for excellent research assistance.