

**Uncovering Yield Parity\***  
**Zsolt Darvas<sup>•</sup> – Gábor Rappai<sup>§</sup> – Zoltán Schepp<sup>+</sup>**

Abstract

This paper suggests a new explanation for the UIP-puzzle maintaining rational expectations and risk neutrality. The model builds on the interaction of foreign exchange and fixed income markets. Ex ante short run and long run UIP and the EHTS is assumed. We show that ex post failures of the EHTS could lead to short run exchange rate movements which is similar to observed data. We present evidence on ex post validity of long run UIP and strikingly new evidence on the stationarity of the long forward exchange rates of major currencies. We set up, calibrate and simulate a stylized model that well captures the observed properties of spot exchange rates and UIP regressions of major currencies. We define the notion of yield parity and test its empirical performance for monthly and daily series of major currencies with favorable results.

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• Corresponding author: Magyar Nemzeti Bank and Corvinus University Budapest, email: [darvaszs@mnbb.hu](mailto:darvaszs@mnbb.hu), address: Szabadság tér 8-9, Budapest, Hungary 1054, tel: +36-1-4282600, fax: +36-1-428-2590

§ University of Pécs, email: [rappai@ktk.pte.hu](mailto:rappai@ktk.pte.hu)

+ University of Pécs, email: [schepp@ktk.pte.hu](mailto:schepp@ktk.pte.hu)