Two-Country Dynamic Nelson－Siegel Model and Uncovered Interest Rate Parity

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Abstract

This paper investigates the predictability of the future exchange rate changes based on a new model. This paper calls the model as "Two-Country dynamic Nelson－Siegel model" and the model is a relaxed restriction model of relative Nelson－Siegel model proposed by Chen and Tsang (2013). Using Monte Carlo experiments, this paper shows that the predictability of the future exchange rate changes based on the new model is superior to the models based on the relative Nelson－Siegel model. Moreover, this paper provides the evidence that relative slope factor is related with the recession as well as a slope factor as previous studies have shown.

Key word: exchange rate, term structure of interest rate, predictability, financial crisis

JEL Classification:

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