The Forward Bias Puzzle and Nonlinearity in Deviations from Uncovered Interest Parity: A New Perspective

Lucio Sarno, University of Warwick

Giorgio Valente, University of Warwick

and

Hyginus Leon, International Monetary Fund

Abstract

We provide empirical evidence that deviations from the uncovered interest rate parity (UIP) condition display significant nonlinearities, which have a natural interpretation consistent with several recent theories based on transactions costs or limits to speculation in the foreign exchange market. This evidence suggests that the forward bias documented in the literature may be less indicative of major inefficiencies in the foreign exchange market than previously thought. Further, Monte Carlo experiments allow us to reconcile our results with the large empirical literature on the forward bias puzzle since we show that, if the true data generating process of UIP deviations were of the nonlinear form we consider, estimation of conventional linear spot-forward regressions would generate the well known anomalies documented in much previous research.