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Effect of Net Foreign Assets on Persistency of Time-Varying Risk
Premium: Evidence from the Dollar-Yen Exchange Rate

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Abstract

In this paper, I focus on the time-varying and persistent exchange rate risk premiums in uncovered interest rate parity associated with changes in net foreign assets. The results of my analyses of the Dollar-Yen exchange rate provide evidence consistent with my risk premium formulation and the predictability of current account balances. I contend that the strong persistent effect causes nominal exchange rates to appear non-stationary in level. I also argue that the present value model of the level of exchange rates combined with the AR(1) approximation for interest rate differentials can reconcile a failure of uncovered interest rate parity.

JEL classification: F31, F32, F47, G12, G15

Keywords: Uncovered interest rate parity, Time-varying risk premium, Nominal exchange rate stationarity, Current account balance

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