

# Does the uncovered interest parity puzzle hold in Central European economies?

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## Abstract

This paper tests the UIP (or forward premium) puzzle in the Czech Republic, Hungary, Poland, and Romania, as well as their aggregates V3 and V3R, from 1999 to 2018. The UK is included as a benchmark case. The relationship is verified against three major currencies: EUR, USD, and CHF, for 1-month and 3-month money market interest rates. We check whether extensions of the baseline model, specification including a realized volatility measure and a GARCH model, account for the UIP puzzle. We find strong confirmation of the UIP puzzle for EUR, CHF, and much weaker evidence for USD, irrespective of the baseline model extensions. Second, the UIP puzzle against EUR holds for all the CEE economies except for the Czech Republic. Third, models extended with realized variance (of daily returns) or conditional variance (GARCH) perform considerably better than the baseline specification, but they do not "solve" the puzzle in any of the cases; on the contrary, they support this anomaly. Fourth, significant and time-varying risk premium in UIP is found in all the CEE countries cases; they may compensate for exchange rate or default risks, and should be explicitly included in empirical UIP studies.

**JEL classification:** F31, F41

**Key words:** exchange rate, open economy macroeconomics, uncovered interest rate parity

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