ABSTRACT
This paper adopted one step estimation to construct dependence-switching copula model to capture the dynamic correlation coefficient between exchange rate changes and interest rate differentials. The model allows the correlation between variables switching from positive (the failure of UIP puzzle) to negative (the hold of UIP puzzle) and vice versa. Meanwhile, the advantages of this model can explore the statistical characteristics (mean and variance) of exchange rate changes and interest rate differentials under the UIP puzzle regime. Furthermore, we also examine time-varying correlation of the above two variables, which is crucial for us to understand the factors that cause the failure of UIP.

Keywords: UIP; copula; dependence switching; carry trade

REFERENCES