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Abstract
The uncovered interest parity (UIP) has been rejected in most of empirical studies (Froot and Thaler,1990) and also documented with augemented Dickey-Fuller test (ADF test), cointegration test ,and panel unit root test in conventional linearity structure (Taylor and Sarno,1998; Wu and Chen,1999; Wu and Lee,2001).
Linear models imply residual of model adjust to equilibrium by fixed speed. If dynamic adjustment of nonlinear model exist, linear model is hard to capture dynamic adjustment. Ender (1995) also mentioned that cointegration has long linear relationship in variables. Theoretically, nonlinear relationship may be existential. Furthermore, some literatures demonstrate how transaction cost and technical analysis induce nonlinear adjustment of the deviation of equilibrium exchange rate (Dumas,1992; Chen and Wu,2000; Taylor and Allen,1992).
Recently, nonlinearity in exchange rate is attractive and growing in empirical studies. Hence, first, we use smooth transition autoregression model (STAR) developed by Granger and Terasirta (1993) and Terasirta (1994) to investigate dynamic adjustment of deviation of UIP in Asian markets. Second, this study is an attempt to examine whether the UIP hold in Asian markets by applying the newly developed nonlinear unit root test advanced by Kapetanois et al. [Journal of Econometrics 112(2003) 359-379].
The results reveal that for small deviation of UIP is described by a random walk, whereas for larger deviation is clearly mean-reverting. Furthermore, the results of nonlinear unit root test show UIP hold for most Asian markets. We find that use of nonlinear unit roots test is able to have strong evidence to support that the UIP hold in most Asian markets, whereas the augmented Dickey-Fuller test based on the conventional linear model cannot.
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