

3)

Test for UIP conditional on regimes

Model comparison – UIP Testing

We may suggest that UIP holds in 'normal' times, but is violated in 'non-normal' times

The sequences of switching between the two states may help us learning what drives the UIP puzzle

Therefore we need two separate mean equations to be estimated

$$\text{Regime1} : \mu_{1t} = \alpha_1 + \beta_1(i_{t-1} - i_{t-1}^*); h_{1t} = \sigma_1^2$$

$$\text{Regime2} : \mu_{2t} = \alpha_2 + \beta_2(i_{t-1} - i_{t-1}^*); h_{2t} = \sigma_2^2$$