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Can Policy Uncertainty Drive the Dollar?

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Keywords

exchange rates, currency risk premia, policy uncertainty

Abstract

This article reviews the risk-based literature on international arbitrage deviations, exchange rates, and countries' borrowing costs. It synthesizes recent work identifying policy uncertainty as a key primitive in risk-based models of global finance and investment. Volatile and unpredictable policy environments alter forward-looking investors' expectations and portfolio decisions, thereby influencing exchange rates, excess currency returns, and the cost of capital—effects especially pronounced in emerging markets. We discuss how increased global policy uncertainty can create conditions under which a policy risk premium also arises for the US dollar. We present preliminary evidence consistent with this hypothesis.

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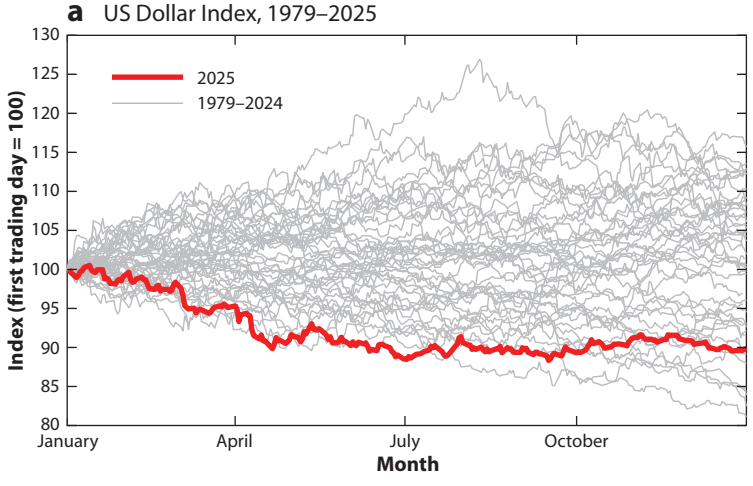
1. INTRODUCTION

The year 2025 saw one of the most pronounced depreciations of the US dollar in decades. Over the full year, the dollar declined by 10.16% relative to its value at the beginning of the year (see **Figure 1*a*,*b***). Among previous episodes of comparable magnitude reported in **Figure 1*b***, there are no common visible characteristics: The year 1990 coincided with a recession, 1986 was associated with a sharp collapse in oil prices, and 1987 corresponded to a major stock market correction. Other years of substantial dollar depreciation occurred during periods of economic expansion and some were associated with capital outflows from the United States, such as 1987 and 1990. It is clear that the 2025 depreciation is not the result of a mass rush out of US assets, as the roaring stock market tells otherwise. There seems to be an emerging trend, though, known as Hedge America (Xie, Johnson & Andrianova 2025), where more investors investing in US assets are hedging against the future risk of dollar depreciation. Why are investors hedging such risk, and where do these risks come from? These are the fundamental questions on which this article focuses.

The dollar's decline began early in 2025, following the inauguration of the Trump administration, and intensified after the Liberation Day tariff shock in April 2025, slowing down in June, as visible in **Figure 1**. A defining characteristic of this period in question has been a marked increase in policy uncertainty—not only in trade policy but also in areas such as immigration and fiscal governance (Gopinath 2025). This raises a central question: Could heightened policy uncertainty be the fundamental driver behind the dollar's weak performance thus far?

The answer to this question is of first-order importance. In Section 2, we begin with definitions and a literature review. In Section 3, we then present a stylized model that organizes three channels through which policy uncertainty can affect the exchange rate: demand, supply, and deviations from uncovered interest parity (UIP). In Sections 4 and 5, we review empirical measures of uncertainty and UIP deviations. In Section 6, we return to the 2025 episode and present preliminary evidence on how policy uncertainty can help explain the dollar's depreciation.



b Years with the largest US dollar depreciation

Year	Depreciation
1985	18.90 %
1987	17.53%
1986	16.10%
2003	15.60%
2002	12.04%
1990	10.88%
2017	10.26%
2025	10.16%
1994	8.50%
2007	7.82%

Figure 1

Yearly performance of the US dollar, 1979–2025. Panel *a* shows the US Dollar Index within each year, normalized to 100 on the first trading day of the year; gray lines show 1979–2024, and the red line shows 2025. Panel *b* lists the years with the largest US dollar depreciations from January 1 to December 31. Data from Federal Reserve Economic Data (FRED).

2. LITERATURE REVIEW

A growing body of research shows that countries with risky currencies, defined as currencies that depreciate in bad times, face higher borrowing costs—manifested as external finance premia (inclusive of country and currency risk)—when they borrow in their own currency in international markets. Countries with safer currencies, on the other hand, such as the United States, benefit from lower financing costs on their debt through convenience yields. Historically, most other countries could not borrow in their own currency and instead borrowed in dollars, as international investors and lenders do not want to take currency risk on top of an inherent risk of default underlying both dollar and local-currency borrowing. This is termed "original sin" by Eichengreen, Hausmann & Panizza (2005).

We offer two key interest parity definitions. Throughout this literature review, we use the following notation: Variables without an asterisk refer to the currency or country under discussion, while variables with an asterisk refer to the relevant foreign or reference currency.[1] Let s_t denote the log nominal exchange rate, measured as the domestic-currency price of the foreign or reference currency, and let i_t and i_t^* denote domestic and foreign/reference interest rates over horizon h. UIP is the condition that, absent risk compensation, the home-minus-foreign interest rate differential equals the expected depreciation of the home currency:

$$i_t - i_t^* = \mathbb{E}_t s_{t+h} - s_t, \qquad \psi_t \equiv (i_t - i_t^*) - (\mathbb{E}_t s_{t+h} - s_t).$$

Thus, UIP holds when $\psi_t = 0$, rendering savers indifferent in parking their savings in assets denominated in different currencies at default-risk-free interest rates. A nonzero ψ_t is an ex ante excess return on the home-currency asset relative to the foreign-currency asset. When the interest rates are default-risk-free, ψ_t is naturally interpreted as a currency risk premium: the compensation investors require for holding an asset whose payoff is exposed to future exchange rate movements. Empirically, $\mathbb{E}_t s_{t+h}$ can be measured using survey expectations; replacing it with the realized s_{t+h} instead combines the ex ante premium with forecast errors and shocks realized after date t. The Fama regression and the forward premium puzzle are empirical ways of organizing this distinction: The former relates realized depreciation to the interest differential or forward premium, while the latter refers to the empirical tendency for high-interest-rate currencies to earn positive excess returns rather than depreciate as UIP predicts.

Covered interest parity (CIP) replaces the uncertain future spot rate with a forward contract. Let $f_{t,t+h}$ denote the log forward exchange rate set at date t for delivery at $t + h$. In logs, CIP is

$$i_t - i_t^* = f_{t,t+h} - s_t, \qquad \kappa_t \equiv (i_t - i_t^*) - (f_{t,t+h} - s_t).$$

CIP holds when $\kappa_t = 0$. Because the forward contract locks in the exchange rate, CIP deviations do not reflect compensation for bearing future currency risk in the same sense as ψ_t. Instead, κ_t captures hedging costs, intermediary balance sheet constraints, convenience yields, and, when the underlying instruments are not matched default-risk-free claims, differences in default risk. This distinction is central for what follows: UIP deviations speak to expected, unhedged currency risk compensation, whereas CIP deviations strip out currency risk mechanically and therefore help isolate financing and hedging frictions, convenience yield, and default risk. Notably, UIP deviations nest CIP deviations and additionally include the forward currency risk premium, $f_{t,t+h} - \mathbb{E}_t s_{t+h}$.

The literature studies currency risk versus default risk in separation. An early example is by Du & Schreger (2016), who isolate local-currency sovereign spreads from currency compensation

[1]Equivalently, in a panel of countries one could write $s_{j,t}$, $i_{j,t}$, $\psi_{j,t}$, and $\kappa_{j,t}$ for country j. We omit the multicountry subscript here for simplicity.

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by using cross-currency swaps and calculating deviations from CIP between government bond yields. However, separating default risk from currency risk today would not allow us to calculate how much of future expected currency risks are priced in by forward-looking investors today. As we argue below, movements in the UIP premium, measured with short-term (less than 12 months) interest rates on savings deposits/money market rates and/or with 3-month local-currency government bond rates combined with survey data on future expectations of the exchange rate, can pick up such forward-looking currency risk pricing of investors.[2]

It is well-established that there are systematic violations of UIP. These violations produce persistent ex ante and ex post excess currency returns to savers in specific currencies. UIP failures are so widespread across currencies, countries, borrowers, savers, and investors that even within domestic financial markets, where the same firm borrows in different currencies from the same financial intermediary (Di Giovanni et al. 2021), there is a wide UIP wedge—up to a 7-percentage-point (PP) differential in local firm-level spreads depending on the currency of debt. These persistent deviations from UIP (currency risk premia) are closely linked to both global risk sentiment [e.g., as measured by the CBOE Volatility Index (VIX) in Kalemli-Özcan 2019] and local policy uncertainty (e.g., Kalemli-Özcan & Varela 2021), measured with volatility of policy news à la Baker, Bloom & Davis (2016).[3]

There is also work that categorizes currencies as risky versus safe, where this categorization is interpreted as heterogeneous loadings on global risk that drive heterogeneous excess currency returns (realized, not expected) for currencies that depreciate in bad times versus the ones that do not, as in Lustig & Verdelhan (2007). Benigno, Benigno & Nisticò (2012) document that whether a currency appreciates or depreciates with uncertainty depends on its safety. Later work argued that most of the variation in these heterogeneous loadings is country specific (time invariant) and hence captured by the persistent interest rate differentials, which then lead to differences in excess currency returns (Hassan & Mano 2019). This line of work argues that key primitives underlying the heterogeneous loadings will be factors such as country size (Hassan 2013), the country's trade network centrality (Richmond 2019), or the wide use of a given currency in global trade invoicing (Gopinath & Stein 2021). A key implication of this literature is that safe countries accumulate more capital than risky countries (Hassan & Zhang 2021), given their low cost of financing debt and hence low cost of capital investment.

A different strand of the literature argues that both cross-sectional and time-varying currency risk premia can be explained by frictional financial intermediation in the global capital markets (Gabaix & Maggiori 2015; Itskhoki & Mukhin 2021; Dao, Gourinchas & Itskhoki 2025). Brunnermeier, Nagel & Pedersen (2008) provide a closely related carry trade mechanism, showing that high-interest-rate investment currencies earn positive average excess returns but are exposed to crash risk when carry trades unwind as speculators approach funding constraints. Similar to Kalemli-Özcan & Varela (2021), this line of work argues that UIP premia move with currency-specific demand shocks, regardless of where they come from or how they change. What matters in

[2]Short-maturity instruments are used in this context, since these are as close as possible to default-risk-free within each currency.

[3]UIP deviations, regardless of their link to policy uncertainty, play a central role in the international transmission of shocks—particularly in the spillover effects of US policies and global financial conditions (e.g., Kalemli-Özcan 2019; Akinci, Kalemli-Özcan & Queralto 2022), and consequently in the effectiveness of policies designed to mitigate such spillovers (e.g., Basu et al. 2025). UIP deviations can additionally explain differing exchange rate puzzles across emerging versus advanced economies (Soylu 2025) and are central to exchange rate determination in general equilibrium (Itskhoki & Mukhin 2021, Chahrour et al. 2024, Kekre & Lenel 2024).

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these models is that exchange rate depreciations are followed by predictable appreciations, generating positive excess currency returns required to ensure intermediation of currency demand shocks. So far there is no empirical evidence supporting this theoretical channel that frictional intermediation is the culprit for cross-sectional and time-varying UIP deviations. Moreover, this theoretical literature is also silent on the underlying primitives behind the heterogeneous currency demand shocks (or heterogeneous loadings on global risk for risky versus safe currencies). Both theoretical and empirical literatures are also silent on the differences between realized excess returns, UIP (expected excess returns), and CIP (convenience yields/hedging costs or hedged returns). In fact, in most of the models in the tradition of Gabaix & Maggiori (2015), CIP holds, and exchange rate depreciations are not always followed by predictable appreciations in emerging market data. Understanding these differences between UIP, CIP, and excess currency returns is of first-order importance to understand the primitives underlying endogenous UIP deviations, in both a static sense and a dynamic sense, and hence how policy uncertainty shapes expectations of investors about the future performance of a given currency.

Our view emphasizes the time-varying nature of currency risk premia and therefore links naturally to fluctuations in policy uncertainty. A policy uncertainty shock is distinct from news about the expected level of policy. A first-moment policy shock changes the expected tariff, tax, deficit, or policy rate, while a policy uncertainty shock instead widens the conditional distribution of future policy outcomes. Time variation in policy uncertainty (e.g., low yesterday and high today) means that investors face a distribution of several expected outcomes that can differ widely under uncertain monetary, fiscal, and trade policies. This approach is in line with the broader uncertainty literature. Bloom (2009) finds that the uncertainty following time-varying, second-moment shocks generates a drop in output and employment as firms reduce investment and hiring. Alfaro, Bloom & Lin (2024) show that financial frictions amplify uncertainty shocks, as is also the case in Akinci, Kalemli-Özcan & Queralto (2022), where frictions lead to endogenous risk aversion, addressing the long-standing problem of standard macro models generating small risk premia. Rare disasters such as major financial crises (Farhi & Gabaix 2016) can also generate similar patterns. Pástor & Veronesi (2012) develop a general equilibrium model in which government policy changes affect stock prices, volatility, correlations, and risk premia. Pástor & Veronesi (2013) show that political uncertainty commands a risk premium that is larger when economic conditions are weak and when policy uncertainty is already high.

Taken together, these literatures suggest that the UIP risk premium can have both a global component, on which currencies load heterogeneously, and a local component, as shown by Kalemli-Özcan & Varela (2021). With the notation used here, we write

$$\psi_t = \lambda \psi_t^{\mathrm{G}} + \psi_t^{\mathrm{L}},$$

where λ captures the loading of the currency under consideration on the global risk factor, ψ_t^{G}, and ψ_t^{L} is the local component. This representation also has a natural interpretation as a factor model for currency risk premia.[4]

Within this decomposition, policy uncertainty at the country level operates mainly through the local component, ψ_t^{L}. Local policy uncertainty captures country-level fiscal, regulatory, monetary, trade, or political instability. Where λ is small or the volatility of ψ_t^{L} is high, local measures of risk will have strong explanatory power for expected depreciation. Local policy, and uncertainty

[4]In panel notation, this corresponds to $\psi_{j,t} = \lambda_j \psi_t^{\mathrm{G}} + \psi_{j,t}^{\mathrm{L}}$, where λ_j is country j's loading on the global factor. Local risks and country-weighted global risks can be correlated, though they are not perfectly correlated, as shown by Kalemli-Özcan & Varela (2021): In multiple regressions, each has separate explanatory power with high partial R^2 values.

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thereof, can also alter the effective loading λ by changing the extent to which global shocks are transmitted domestically. For instance, a country that undertakes reforms that strengthen the institutional framework around fiscal and monetary policy may see both a decline in the volatility of ψ_t^L and a reduction in λ, as global risk shocks are absorbed more by domestic balance sheets and less by the exchange rate. By contrast, episodes of erratic policymaking, institutional erosion, or ad hoc capital-flow management measures can simultaneously raise the variance of ψ_t^L and increase λ, making the currency more exposed to swings in global financial conditions.

As for the global risk factor, ψ_t^G, the emphasis in the literature has been traditionally on global sources of uncertainty—geopolitical tensions, global trade policy shifts, and common shocks to international financial conditions. In our notation, such forces correspond to movements in ψ_t^G, with each country loading on this global component through its weight λ. Countries that are more financially integrated, more exposed to dollar-denominated liabilities, or more dependent on global intermediaries can exhibit larger λ and therefore stronger sensitivity to global uncertainty shocks. This matches the empirical observation that a single global factor—captured by measures such as the VIX, US monetary policy uncertainty, or global economic policy uncertainty (EPU)/geopolitical risk (GPR) indices—explains a large share of the variation in UIP premia across countries.

The global financial cycle literature has established the special role that US monetary policy plays. Miranda-Agrippino & Rey (2020) show that US monetary policy plays the central role in driving the global financial cycle. A tightening of US monetary policy depresses risky asset prices, triggers deleveraging by global financial intermediaries, contracts domestic and cross-border credit, and tightens financial conditions internationally. In the spirit of Rey's dilemma, these spillovers occur even for countries with floating exchange rates, underscoring the dominant influence of US monetary policy on global financial conditions.

The dollar is therefore not simply another currency in a cross section of high- and low-interest-rate currencies. Gourinchas, Rey & Sauzet (2019) emphasize that the United States has historically enjoyed an exorbitant privilege, earning excess returns on external assets, while also bearing an exorbitant duty by providing insurance to the rest of the world in global crises. Lilley et al. (2022) document an "exchange rate reconnect" after the global financial crisis: Measures of global risk appetite that previously had little comovement with exchange rates became significantly related to the dollar, consistent with a strengthened safe-haven role. Farhi & Maggiori (2018) provide a model of the international monetary system in which reserve-asset provision can be organized around a hegemon or a multipolar system, with Triffin-style fragilities arising from the interaction of reserve demand and reserve supply. These papers define the benchmark for the 2025 episode: If US policy uncertainty makes the dollar behave more like a risky currency, the relevant question is whether it weakens the safe-haven and reserve-currency properties that normally distinguish the dollar.

This is where the safe asset literature becomes central. A distinct strand of the literature interprets low yields on US Treasuries and a few other sovereign debts as reflecting a convenience yield or safe asset premium: Investors accept lower returns in exchange for liquidity services, collateral value, and safety (Krishnamurthy & Vissing-Jorgensen 2012; Caballero, Farhi & Gourinchas 2017; Du, Im & Schreger 2018; Jiang, Krishnamurthy & Lustig 2018; Obstfeld & Zhou 2022). He, Krishnamurthy & Milbradt (2019) show theoretically that safe asset status is relative and demand dependent: An asset is safe not only because its own fundamentals are strong but also because its safety is evaluated relative to the supply and safety of competing assets. Jiang, Krishnamurthy & Lustig (2021) link the dollar exchange rate to foreign investors' demand for US safe assets, showing that the Treasury basis contains information about the convenience yield embedded in dollar assets. In this view, differences in risk-free interest rates across currencies reflect both exchange

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rate risk and the special role of some sovereign bonds as global collateral and liquidity. Policy uncertainty can affect this convenience yield directly and thereby alter both global safe rates and the pricing of currency risk.

This can complicate the framing of global versus local policy uncertainty for the United States and US dollar, especially in 2025, when the United States is behaving like an emerging market with elevated policy risk in several dimensions. Shocks that make the dollar a riskier currency are shocks to both ψ_t^{L} and ψ_t^{G}. Moreover, it is possible that two forces are clashing: The erratic trade policy makes the dollar riskier, and the global uncertainty that it generates can create a flight to safety. To understand these forces at play, it is helpful to decompose the UIP premium that the United States faces in light of the safe asset status of the US dollar. From the US point of view, this implies that the local component of ψ_t can further be decomposed into a foreign exchange (FX) risk premium and a convenience yield term. Recalling $\psi_t = \lambda\psi_t^{\mathrm{G}} + \psi_t^{\mathrm{L}}$, let

$$\psi_t^{\mathrm{L}} = \psi_t^{\mathrm{L,FX}} + \psi_t^{\mathrm{L},\chi},$$

where $\psi_t^{\mathrm{L,FX}}$ is the local (policy-driven) FX risk premium and $\psi_t^{\mathrm{L},\chi}$ captures the convenience yield differential associated with US Treasuries. A convenient reduced-form expression is $\psi_t^{\mathrm{L},\chi} \equiv -\left(\chi_t^{\mathrm{USD}} - \chi_t^{*}\right)$, with χ_t^{USD} denoting the convenience yield on US Treasuries and χ_t^{*} denoting the corresponding convenience yield on the foreign safe asset. A decline in the relative convenience yield, $\chi_t^{\mathrm{USD}} \downarrow$, therefore maps directly into a positive shock to the UIP wedge,

$$\chi_t^{\mathrm{USD}} \downarrow \implies \psi_t^{\mathrm{L},\chi} \uparrow,$$

which in our framework behaves exactly like a policy-driven increase in ψ_t. From this perspective, some part of the UIP wedge, for safe currencies, is not purely compensation for currency risk but reflects scarcity and perceived safety of particular sovereign bonds. Policy uncertainty enters this decomposition through at least two channels. First, it can change sentiment on FX volatility, expected default, inflation, or financial repression, affecting the local FX-risk-premium component $\psi_t^{\mathrm{L,FX}}$. Second, it can change the relative convenience yield on sovereign safe assets, $\chi_t^{\mathrm{USD}} - \chi_t^{*}$, thereby shifting the convenience yield component of the UIP wedge.

A credible, predictable policy regime can therefore sustain a high χ_t^{USD} and a correspondingly negative $\psi_t^{\mathrm{L},\chi}$, while an environment of erratic or confrontational policy can erode χ_t^{USD} and push $\psi_t^{\mathrm{L},\chi}$ upward. The Hedge America pattern is about investors hedging either because $\psi_t^{\mathrm{L,FX}}$ has risen or against the possibility that χ_t^{USD} may decline.

The safe asset scarcity view (Caballero, Farhi & Gourinchas 2017) posits that a short supply of genuinely safe assets elevates convenience yields on existing safe bonds. In a world where US Treasuries and a handful of other sovereigns are the main suppliers of safe collateral, the mapping from policy uncertainty to safe asset scarcity would be as follows:

- Local US policy uncertainty—about trade policy, the fiscal regime, debt sustainability, or the willingness to honor obligations (for instance, repeated debt-ceiling crises)—can reduce the perceived safeness of Treasuries and amplify dollar volatility, increasing $\psi_t^{\mathrm{L,FX}}$ and lowering χ_t^{USD} and, for a given foreign/reference safe rate i_t^{*}, raising observed yields.
- Global policy uncertainty—about trade wars, sanctions, geopolitical conflict—can increase demand for dollar safe assets if investors view the United States as a relatively stable anchor, raising χ_t^{USD}.

These mechanisms link directly to the conceptual framework via the UIP premium, ψ_t. Episodes such as the UK mini-budget (the Growth Plan) and Liberation Day tariffs illustrate these mechanisms: Long-dated gilt and Treasury yields rose, the British pound and the US dollar depreciated against the euro, and market commentary explicitly invoked concerns about institutional quality and policy credibility.

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3. CONCEPTUAL FRAMEWORK

To organize the discussion, we present a simple setup where policy uncertainty can be embedded into a simple, open-economy, dynamic general equilibrium framework. To keep the model tractable, we remain agnostic about whether policy uncertainty will show up as a demand shock, a supply shock, or an exogenous change in the UIP wedge whose origin we leave unmodeled (i.e., exogenous intermediation shock). Facing higher macro volatility, households can lower consumption demand with a precautionary saving motive, which can show up as either lower or higher currency demand or lower or higher currency supply. If firms face uncertainty, they can slow down investment while they wait for uncertainty to be resolved, which again can lead to changes in both demand and supply of currencies. Investors facing policy uncertainty may demand to be compensated with a higher currency risk premium for holding the assets that are affected by elevated uncertainty.

To explore these aspects, let us consider a setup based on Kalemli-Özcan, Soylu & Yıldırım (2025), with two countries (home and foreign) and one good, whereby output is exogenous (endowment) and monetary policy fixes the price level in both countries. While this exercise involves a simple first-order approximation that by construction does not have second-moment shocks to map directly to policy volatility, our goal here is to establish a framework for currencies with demand, supply, and exogenous intermediation shocks, as policy uncertainty, in principle, can be the primitive underlying all of these shocks.

The resulting model includes the following endogenous variables, expressed in percent deviations from their deterministic steady state: $p_{\mathrm{H},t}$, the price of home goods produced and consumed domestically; $p^*_{\mathrm{F},t}$, the price of foreign goods produced and consumed abroad; s_t, the nominal exchange rate (the home-currency price of the foreign currency); i_t and i^*_t, nominal interest rates in the home and foreign countries, respectively; b_t, the net foreign asset position of the home country, inclusive of interest payments; and c_t and c^*_t, consumption of home and foreign households. The exogenous variables are ϵ^d_t, a domestic demand shock entering the Euler equation; ψ_t, a time-varying wedge in the UIP condition (UIP premium); and y_t, output endowment in the home country. The structural parameters are $\sigma > 0$, the inverse of the intertemporal elasticity of substitution; $1 - \gamma$, denoting home bias; β, the households' discount factor; and $\theta > 0$, the elasticity of substitution in the constant elasticity of substitution (CES) aggregator. Throughout this section and in the article an asterisk denotes foreign country and lack thereof denotes home country.

In agreement with the standard simplifications in the literature, for tractability, if we assume symmetry of home bias, then the five-equation representation of Kalemli-Özcan, Soylu & Yıldırım (2025) yields the following linearized equilibrium conditions in line with Obstfeld & Rogoff (1995), Itskhoki & Mukhin (2021), and Kekre & Lenel (2024).

Definition 1. An approximated equilibrium comprises eight sequences $\{p_{\mathrm{H},t}, p^*_{\mathrm{F},t}, s_t, i_t, i^*_t, b_t, c_t, c^*_t\}_{t=0}^{\infty}$ such that, given exogenous variables $\{\epsilon^d_t, \psi_t, y_t\}_{t=0}^{\infty}$, Equations 1–8 hold:

1. The Euler equation holds in both countries:[5]

$$\sigma(\mathbb{E}_t c_{t+1} - c_t) = i_t + \epsilon^d_t \qquad 1.$$

[5] In the case of constant absolute risk aversion (CARA) utility, the impact of volatility can be seen as follows: $\sigma(\mathbb{E}_t c_{t+1} - c_t) = i_t + \frac{1}{2} Var(c_{t+1})$, as shown in Kalemli-Özcan, Soylu & Yıldırım (2026a). Here we represent this in reduced form with ϵ^d_t.

and

$$\sigma(\mathbb{E}_t c^*_{t+1} - c^*_t) = i^*_t. \quad 2.$$

2. The aggregate consumption basket's price yields the following expressions when the price level in both countries (p_t, p^*_t) is fixed by policy $(p_t = p^*_t = 0\ \forall t)$:

$$0 = (1-\gamma)\, p_{\mathrm{H},t} + \gamma\,(s_t + p^*_{\mathrm{F},t}) \quad 3.$$

and

$$0 = (1-\gamma)\, p^*_{\mathrm{F},t} + \gamma(p_{\mathrm{H},t} - s_t). \quad 4.$$

3. The UIP condition holds up to a wedge, given persistent UIP violations in the data as discussed in Section 2. The wedge is given by ψ_t:

$$i_t - i^*_t = \mathbb{E}_t s_{t+1} - s_t + \psi_t. \quad 5.$$

4. Goods market clears for each country with foreign output fixed:

$$y_t = (1-\gamma)\,(c_t - \theta p_{\mathrm{H},t}) + \gamma\left(c^*_t + \theta(s_t - p_{\mathrm{H},t})\right) \quad 6.$$

and

$$0 = \gamma\left(c_t - \theta(s_t + p^*_{\mathrm{F},t})\right) + (1-\gamma)\left(c^*_t - \theta p^*_{\mathrm{F},t}\right). \quad 7.$$

5. Balance of payments captures the evolution of b_t, which comprises the net foreign assets of the home country:

$$\beta b_t = b_{t-1} + \gamma\left[(c^*_t - c_t) + \theta s_t + (1-\theta)\left(p_{\mathrm{H},t} - s_t - p^*_{\mathrm{F},t}\right)\right]. \quad 8.$$

Policy uncertainty can lead to a negative demand shock, as shown by a large literature ($\epsilon^d_t \uparrow$).[6] It can alternatively widen the UIP premium ($\psi_t \uparrow$), as shown in Kalemli-Özcan & Varela (2021). Our framework here is more general; changes in ψ_t can come from uncertainty or other primitives, such as from investors' exogenous sensitivity to risk-taking à la Gabaix & Maggiori (2015), nonpecuniary liquidity benefits/convenience yields for safer and liquid non–emerging market currencies like the dollar and euro à la Krishnamurthy & Vissing-Jorgensen (2012) and Engel (2016), country risk à la Kalemli-Özcan (2019), or frictions in intermediation à la Itskhoki & Mukhin (2025). Finally, uncertainty can also disrupt supply chains and act similarly to a negative supply shock ($y_t \downarrow$). To understand the impact of each shock, following the parameterization of Cole & Obstfeld (1991), let us set $\sigma = \theta = 1$ and consider one-time shocks. Using the method of undetermined coefficients, the solution for the exchange rate yields

$$s_t = \underbrace{\beta(1-2\gamma)^2}_{>0}\epsilon^d_t + \underbrace{\beta(1-2\gamma)^2}_{>0}\psi_t + \underbrace{(1-2\gamma)}_{>0}y_t - \underbrace{\frac{(1-\beta)(1-2\gamma)^2}{\gamma}}_{>0} b_{t-1}.$$

Given home bias, $\gamma \in [0, \frac{1}{2})$, a negative demand shock is depreciationary (i.e., an increase in s_t is depreciation). Similarly, a positive shock (risk-off) to the UIP wedge (i.e., an increase in ψ_t) is depreciationary. A positive supply shock (i.e., an increase in y_t) is depreciationary in two-country setups, since it increases the relative abundance of the home good; relatedly, a negative supply

[6]This can be microfounded with CARA utility or Epstein–Zin preferences.

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Table 1 Impact of uncertainty via demand, intermediation, and supply

Shock	s_t	c_t	c_t^*	$i_t - i_t^*$	$\mathbb{E}_t s_{t+1} - s_t$
Uncertainty $\rightarrow \epsilon_t^d \uparrow$	+	−	+	−	−
Uncertainty $\rightarrow \psi_t \uparrow$	+	−	+	+	−
Uncertainty $\rightarrow y_t \downarrow$	−	−	−	+	+

shock makes home goods more scarce and tends to appreciate the home country's currency.[7] Finally, a higher inherited net foreign asset position leads to appreciation via wealth effects but a change in the position that is net capital outflows ($b_t - b_{t-1}$) can lead to depreciation. These effects are consistent with the data.

The solution above implies that uncertainty or volatility shocks that suppress demand and/or widen the UIP premium can depreciate the home country's currency. At the same time, the impact on the exchange rate of a shock to ψ_t is indistinguishable from that of a shock to ϵ_t^d, because the two Euler equations combined with the UIP condition yield the Backus–Smith condition in expectation, whereby both shocks represent deviations from perfect risk-sharing:

$$\sigma\left(\mathbb{E}_t[c_{t+1} - c_{t+1}^*] - (c_t - c_t^*)\right) = \left(\mathbb{E}_t s_{t+1} - s_t\right) + \psi_t + \epsilon_t^d,$$

and hence,

$$\mathbb{E}_t s_{t+1} - s_t = -(1-2\gamma)^2 \epsilon_t^d - (1-2\gamma)^2 \psi_t - (1-2\gamma) y_t.$$

The two shocks' impact on the home and foreign countries' consumption will be as follows. The impact is symmetric given the embedded symmetry in the model. Once again, a demand shock and a UIP shock have the same impact. A negative demand shock to the home country's goods or assets is a positive shock to the foreign country:

$$c_t = \underbrace{-2\beta\gamma(1-\gamma)}_{<0}\epsilon_t^d - \underbrace{2\beta\gamma(1-\gamma)}_{>0}\psi_t + \underbrace{(1-\gamma)}_{>0}y_t + \underbrace{2(1-\beta)(1-\gamma)}_{>0}b_{t-1},$$

$$c_t^* = \underbrace{2\beta\gamma(1-\gamma)}_{>0}\epsilon_t^d + \underbrace{2\beta\gamma(1-\gamma)}_{>0}\psi_t + \underbrace{\gamma}_{>0}y_t - \underbrace{2(1-\beta)(1-\gamma)}_{>0}b_{t-1}.$$

The two shocks differ in their impact on the interest rate and, relatedly, on the interest rate differential:

$$i_t = \underbrace{-(1-2\gamma(1-\gamma))}_{<0}\epsilon_t^d + \underbrace{2\gamma(1-\gamma)}_{>0}\psi_t - \underbrace{(1-\gamma)}_{>0}y_t,$$

$$i_t - i_t^* = \underbrace{-(1-2\gamma)^2}_{<0}\epsilon_t^d + \underbrace{4\gamma(1-\gamma)}_{>0}\psi_t - \underbrace{(1-2\gamma)}_{>0}y_t.$$

With this framework we would expect to see the following signs on macro variables, such as the exchange rate for any general macrolevel uncertainty shock, including shocks to policy uncertainty. This is because a broad class of macro uncertainty shocks can lead to lower demand, a widening of the UIP premium, and lower supply as depicted in **Table 1**. The impact of uncertainty is unambiguously negative on the home country's consumption. For the foreign country's consumption, the sign is generally expected to be positive (as depreciation of the home currency

[7] Two-country models generally have this feature. Negative supply shocks that make the home country's goods more scarce will be appreciationary. Several mechanisms can offset this. For example, if government debt and the probability of default is introduced, negative supply shocks can be depreciationary when they make default more probable.

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makes the home country's goods cheaper for the foreign country's consumption); however, when the negative supply shock aspect dominates, foreign consumption will decline as well. The sign on the interest rate differential depends on which shock dominates. Finally, the exchange rate depreciates if the demand and UIP shocks dominate, whereas it would appreciate if the supply shock dominated.

Using this simple framework, we can interpret different episodes of elevated policy uncertainty in the data in terms of impacts on the exchange rate. While demand and supply shocks are difficult to disentangle in the data, the empirical estimation of UIP deviations offers key insights. Based on the theory above, one can identify episodes of uncertainty that widen the UIP premium as follows: The home country's currency depreciates, the interest rate differential widens, and the home country's consumption declines. Since such episodes are common in the data and the UIP premium can be identified in the data using exchange rate expectation surveys, in the rest of the article we focus on uncertainty shocks that operate via ψ_t. Note that if the exchange rate depreciation is accompanied by further expected depreciation (typical for emerging market currencies, as shown in Kalemli-Özcan & Varela 2021), then interest rate differentials must widen by more than the expected depreciation to be consistent with increasing UIP premia. To take these insights to data, we next turn to measures of uncertainty and UIP deviations.

4. MEASURING UNCERTAINTY

As discussed above, time variation in policy uncertainty generates not a single expected outcome but a distribution of different expected outcomes, also termed "ambiguity" in the literature. This multiplicity of expected outcomes makes measurement of uncertainty empirically difficult. The literature takes three distinct approaches.

A first class of measures focuses on macroeconomic uncertainty in the sense of time-varying second moments of the conditional forecast error. Jurado, Ludvigson & Ng (2015) estimate an econometric measure of macro uncertainty as the conditional volatility of the unforecastable component of a large panel of macro series. Policy uncertainty enters this class of measures indirectly, to the extent that policy risk raises the conditional volatility of macroeconomic forecast errors.

A second class of measures is explicitly news based. Baker, Bloom & Davis (2016) construct an EPU index by counting the frequency of newspaper articles that jointly mention the economy, policy, and uncertainty. Building on this approach, Caldara et al. (2020) construct a trade policy uncertainty (TPU) index from firms' earnings calls, tariff data, and news coverage and show that increases in TPU depress investment and activity. Caldara & Iacoviello (2022) develop a GPR index, capturing adverse geopolitical events and their associated risks from international newspapers.

A third class of measures is market based and directly linked to monetary and financial conditions. Mueller, Tahbaz-Salehi & Vedolin (2017) exploit scheduled Federal Open Market Committee announcement days combined with option-implied interest rate uncertainty to show that excess returns on strategies that short the US dollar and long other currencies are especially large when monetary policy uncertainty in the United States is high.

Figure 2 depicts the TPU and EPU measures of Caldara et al. (2020) and Baker, Bloom & Davis (2016) applied to 2025. Both measures show elevated uncertainty in the lead-up to and after the tariff announcements on Liberation Day. Even as some TPU and EPU are resolved, both measures indicate levels of uncertainty higher than the preceding year.

5. MEASURING UIP DEVIATIONS

We next connect the theoretical UIP wedge, ψ_t, to its empirical counterpart in the data. The UIP condition predicts that the risk-free interest rate differential between two currencies should be

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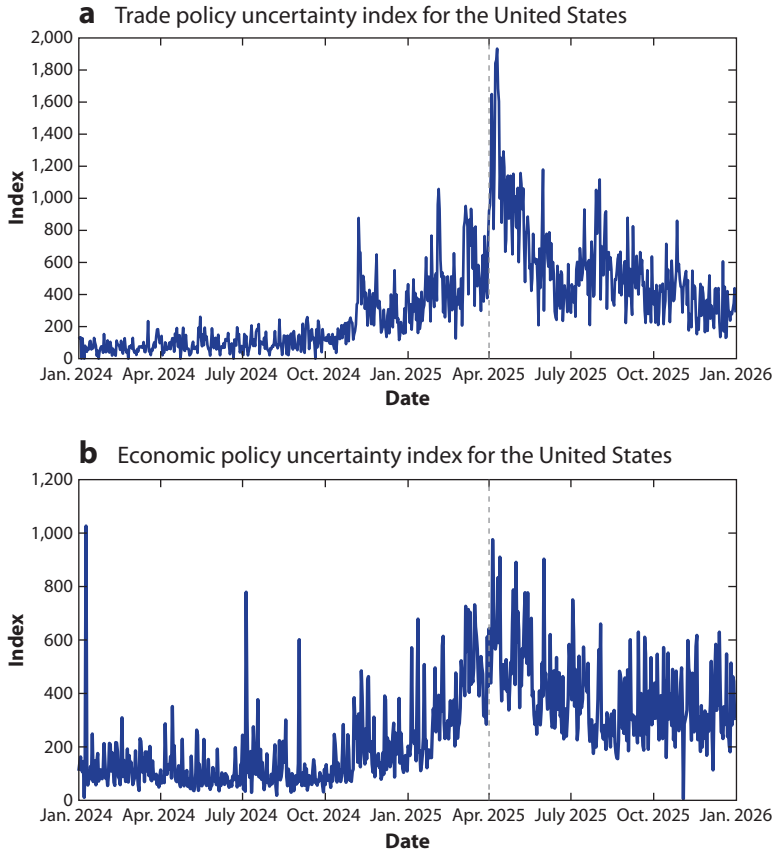

Figure 2

Policy uncertainty indices, daily, January 2024–December 2025. Panel *a* shows the US trade policy uncertainty index of Caldara et al. (2020); panel *b* shows the US economic policy uncertainty index of Baker, Bloom & Davis (2016). Dashed vertical lines mark the April 2, 2025, Liberation Day announcement. Data from Caldara et al. (2020); **https://www.matteoiacoviello.com/tpu.htm**; Baker, Bloom & Davis (2016); and **https://policyuncertainty.com/**.

equal to the expected rate of depreciation of the home currency, over the horizon h, leaving zero excess currency return for the home currency over the foreign currency. Recall that

$$\psi_t = (i_t - i_t^*) - (\mathbb{E}_t[s_{t+h}] - s_t).$$

UIP holds when $\psi_t = 0$. When $\psi_t \neq 0$, there is a UIP wedge; with default-risk-free and otherwise comparable instruments, this wedge is naturally interpreted as a currency risk premium.

If ψ_t (risk premium) is constant, then high-interest-rate currencies should depreciate. Starting with Fama (1984), a large literature with the goal of predicting the change in exchange rates ($s_{t+1} - s_t$) runs the following regression in Equation 9 and shows that high-interest-rate currencies appreciate instead of depreciate:

$$s_{t+1} - s_t = \beta_0 + \beta_1(i_t - i_t^*) + \mu_t, \qquad 9.$$

where β_0 is the intercept, β_1 is the well-known Fama coefficient, and μ_t is the regression residual. Contrary to what one would expect under a constant ψ_t, empirically β_1 is not equal to 1; in fact, it

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is typically below 1 and often negative. As noted by Bansal & Dahlquist (2000), this finding, also known as the forward premium puzzle, is not a pervasive phenomenon, as it shows up only for the advanced country currencies. Bansal & Dahlquist (2000) use data from a mix of emerging and advanced country currencies and show that including emerging markets in the sample is crucial for the finding of high-interest-rate currency depreciations.

Kalemli-Özcan & Varela (2021) show that using survey expectations to measure the expected change, instead of the actual change, in the exchange rate in the Fama regression makes a significant difference. First, the survey-expectations-based UIP wedge shows that UIP approximately holds in advanced economies, on average, and second, not only do high-interest-rate emerging market currencies depreciate, as also shown by Bansal & Dahlquist (2000), but investors persistently expect them to depreciate in the future, not only in bad times. The differences between emerging markets and advanced countries found by these authors are stark. For emerging markets, the mean UIP premium is 4 PP, whereas for advanced economies it is only 1 PP. This means that global investors expect an excess currency return that is four times as large for emerging market currencies as for advanced economy currencies.

Expectations of future exchange rates from a Consensus Economics survey capture ex ante beliefs of major FX participants, yielding an expectational measure of risk compensation that aligns better with the theoretical notion of a priced risk factor. Dorsey-Reyes et al. (2025) compare this survey-data-based currency risk compensation to other market-based and text-based measures of future expectations of exchange rates linked to risk compensation. An advantage of the survey-data-based approach is that it separates beliefs from realizations, which is not something that the literature spanned by the Fama regression had focused on. When one substitutes realized depreciation for expected depreciation, the regression residual mechanically absorbs both forecast errors and all shocks to fundamentals arriving between the forecast date and the realization date.

There is a literature that focuses on the forecast error predictability, starting with Frankel & Froot (1987). In fact, showing ex post predictability of the forecast error for the exchange rates based on interest rate differentials led the literature to conclude that sophisticated investors cannot be making obvious mistakes, so the survey data should be capturing some noise and cannot be used. Such predictability of forecast errors was used as evidence that survey-data-based expectations do not capture rational expectations. It is now well-understood, at least in other contexts (inflation or other asset pricing expectations as opposed to exchange rates), that ex post predictability of forecast errors does not imply that people make "obvious" mistakes that could be easily fixed in real time. Even when conducting a quasi-real-time estimation, an econometrician has ex post knowledge of statistical relationships that would have been much harder to uncover in real time. This logic holds for exchange rates too. The findings of Meese & Rogoff (1983) that a random walk provides the best out-of-sample forecasts for exchange rates do not mean exchange rates are random walks. They imply that the candidate fundamentals in those models did not deliver exploitable out-of-sample forecasting gains. Overall, using data on survey-based expectations to measure the UIP deviations mirrors the empirical asset pricing literature's intuition: Riskier assets carry higher expected returns.

6. POLICY UNCERTAINTY AND THE DOLLAR

With the literature review and the theoretical framework above, we can now return to the depreciation of the US dollar in 2025 and analyze it in terms of policy uncertainty. We use "policy uncertainty" as an umbrella term for several distinct shocks. TPU changes expected relative prices, supply chain costs, and firms' investment incentives. Fiscal policy uncertainty changes expected taxes, debt sustainability, inflation risk, and the possibility of financial repression. Monetary policy uncertainty changes expected short rates, the nominal anchor, and the distribution of future real

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rates. Institutional uncertainty, including uncertainty about central bank independence or the rule of law, changes the perceived safety of domestic-currency assets.

In this section, as an illustrative example, we focus on UIP deviations motivated specifically by TPU given that the increase in the two coincides around Liberation Day, which saw major moves in financial markets (Kalemli-Özcan, Soylu & Yıldırım 2026a).[8] Notably, in the theoretical framework, the impact of uncertainty on the exchange rate via demand, ϵ_t^d, and via the UIP wedge, ψ_t, is observationally equivalent. Since measuring ϵ_t^d and decomposing how uncertainty operates through different channels can be observationally difficult and since ψ_t is measurable with the survey data described below, here we focus on the latter.[9]

To take theory to data, we measure UIP deviations for the United States using expected changes of the exchange rate at the monthly level from the Consensus Economics survey. The data are available since 1996 for 34 currencies classified as floating exchange rate regimes per Ilzetzki, Reinhart & Rogoff (2019). These expectations are available for 3-, 6-, 12-, and 24-month horizons, where the Consensus Economics survey includes forecasters from global and local investors—banks such as Goldman Sachs, HSBC, JP Morgan, and BNP Paribas. These survey data come as expectations of future changes of every currency vis-à-vis another currency, and hence we can calculate the US dollar expectations vis-à-vis the euro.

The announcement of the Liberation Day tariffs on April 2, 2025, triggered a depreciation of the US dollar against the euro and a simultaneous rise in yields on 10- and 30-year US Treasury bonds (Sindreu 2025, Financial Times 2025). A comparable episode occurred in the United Kingdom on September 23, 2022, when the government unveiled its new growth plan and fiscal budget. This announcement led to a sharp depreciation of the pound and a spike in gilt yields—an event that came to be associated with the "moron risk premium" (Ashworth 2022). What these episodes share is a surge in policy uncertainty caused by inconsistent or poorly communicated monetary, fiscal, or trade measures. This kind of erratic policymaking and perceived governance risk unsettles global investors, prompting them to demand a risk premium for holding dollar- and pound-denominated sovereign debt vis-à-vis safer debt like German bonds (The Economist 2025, Herbert 2025). Even though neither event moved yields at maturities shorter than 5 years as much as exchange rates [as is the case generally for emerging markets during similar episodes, as shown with specific events in Kalemli-Özcan & Varela (2021)], they are still noteworthy for understanding how policy risk can shape currency risk premia and exchange rates.

To analyze these events, let us define the UIP premium with the euro as the reference currency. That is, ψ_t is equal to the expected log euro return on the local-currency bond (i_t^{LC}) minus the log euro return on the euro-denominated bond (i_t^{EUR}). Local currency will be the pound and the dollar during each of these events, and the horizon is 12 months; thus,

$$\text{Expected Excess Returns} \;=\; \psi_t^{\text{LC/EUR}} = i_t^{\text{LC}} - \left(\mathbb{E}_t[s_{t+b}] - s_t\right) - i_t^{\text{EUR}} \qquad 10.$$

[8] TPU as measured by Caldara et al. (2020) and Kalemli-Özcan, Soylu & Yıldırım (2026a) increases around Liberation Day. The UIP wedge increases in the same time period.

[9] Kalemli-Özcan, Soylu & Yıldırım (2026b), which extend Kalemli-Özcan, Soylu & Yıldırım (2026a), ask why the dollar depreciated in 2025 when the textbook benchmark predicts appreciation. In their two-country model with segmented financial markets, tariff volatility enters the UIP condition as a risk premium and the Euler equation as precautionary saving. Using a time-stamped database of communicated US tariff rates, they show that in high-frequency windows around announcements, a rise in tariff uncertainty depreciates the dollar and lowers equities while the interest differential stays essentially unchanged; the uncertainty channel accounts for the depreciation at announcement frequencies. As Kalemli-Özcan, Soylu & Yıldırım (2026b) do, tracking additional variables for which the impact of ϵ_t^d and ψ_t differ, such as the interest rate differential as noted in **Table 1**, can shed light on how uncertainty operates through different channels.

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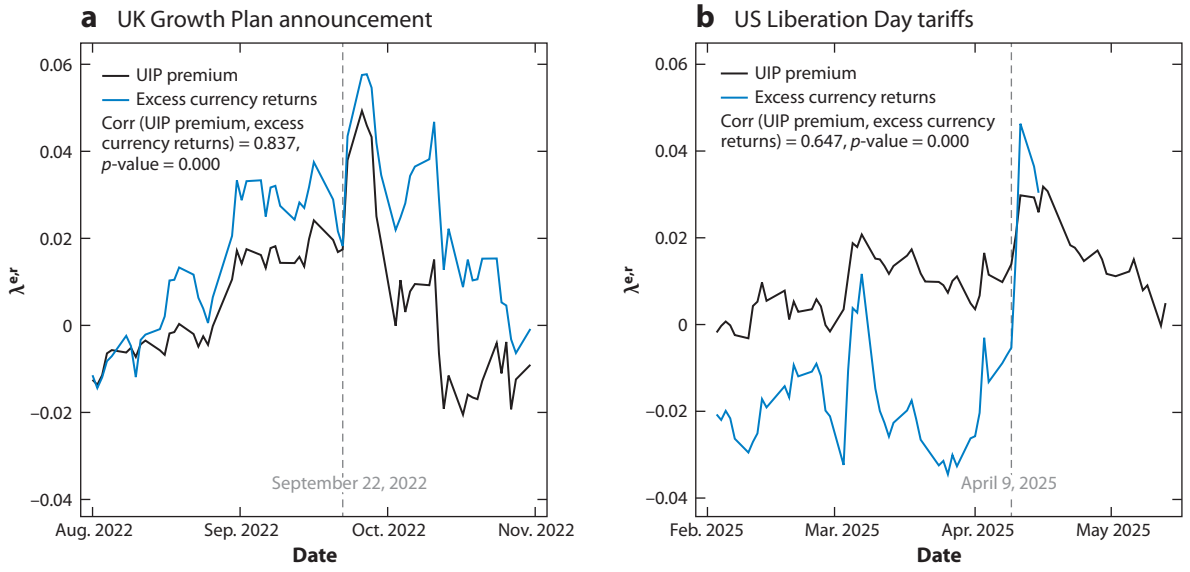

Figure 3

Comparison of the reaction to (*a*) the UK Growth Plan announcement and (*b*) the US Liberation Day tariffs. Data from authors' calculations from Bloomberg client-note expectations, spot exchange rates, and 12-month interest rates. Abbreviation: UIP, uncovered interest parity.

and

$$\text{Excess Returns} = i_t^{\text{LC}} - \left(s_{t+h} - s_t\right) - i_t^{\text{EUR}}. \qquad 11.$$

i_t^{LC} and i_t^{EUR} are the local currency (British pound or US dollar) and the euro 12-month interest rates, s_t is the exchange rate in units of local currency per euro, and $\mathbb{E}_t[s_{t+h}]$ is the expected exchange rate over the next 12 months with $h = 12$. The only difference between these two equations is the use of expected change for the exchange rate for the UIP premium, delivering expected excess returns versus the actual change leading to standard excess currency returns as in the Fama literature.

To capture daily changes in expectations, we use client notes gathered by Bloomberg instead of the surveys by Consensus Economics, as the latter is monthly. Bloomberg collects client notes issued by analysts in different financial institutions and digitizes the expectations of exchange rate depreciation over different horizons that are noted in these client notes. **Figure 3** calculates the UIP premium, for the pound on the left and the dollar on the right, based on the expectations from this data series. Both the pound during the UK Growth Plan announcement and the dollar during the Liberation Day episode depreciated against the euro. As shown in **Figure 3**, both excess currency returns and expected excess currency returns (UIP premium) increase at the time of these announcements.

During both events, the correlation between expected and actual excess currency returns is high, 0.65 and above, implying that perceived policy unpredictability is associated with expected returns demanded by investors. This finding is consistent with **Table 1**, which suggests that depreciationary uncertainty shocks that operate through the UIP premium should see the following signs: The UIP premium widens, the exchange rate depreciates, the interest differential widens, and the exchange rate is subsequently expected to appreciate. **Figure 4** explores this by rebasing each series to zero—on September 22, 2022, the day before the UK announcement, and on

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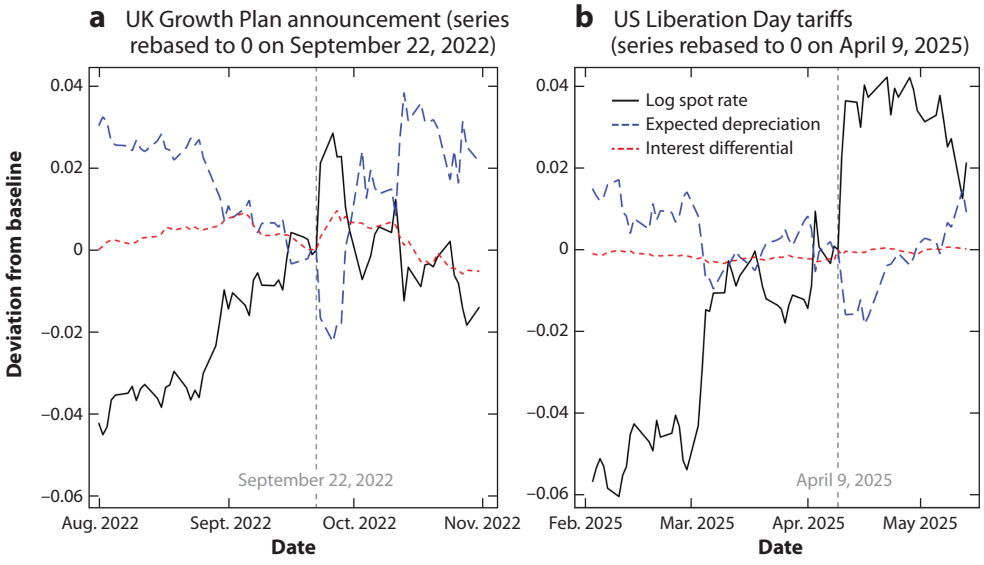

Figure 4

Log spot exchange rate, expected depreciation, and interest rate differential around (*a*) the UK Growth Plan announcement and (*b*) the US Liberation Day tariffs. Series are rebased to zero on September 22, 2022, the day before the Growth Plan announcement, and on April 9, 2025, the day the reciprocal tariffs took effect (*dashed vertical lines*). Data from authors' calculations from Bloomberg client-note expectations, spot exchange rates, and 12-month interest rates.

April 9, 2025, the day the US reciprocal tariffs took effect—to treat that day as an initial steady state or a reference point from which variables deviate to be consistent with the theoretical framework. **Figure 4** depicts that while mild, each of these expected signs holds in the episodes regarding the UK Growth Plan announcement and the Liberation Day tariffs on the same *y*-axis, though the impact on short-term interest rate differentials in the United States is more muted compared to that in the United Kingdom.

A related and important question is when and how policy uncertainty becomes a systematic driver of risk even for currencies deemed safe. Models of country risk and financial repression can generate higher required returns and hence higher long-run natural rates when investors attach more risk to domestic-currency assets (Hassan et al. 2024, Reis 2026). The open questions are, When does policy uncertainty become large enough to raise required returns on long-dated safe assets, and does that repricing migrate down the yield curve as is typical in emerging markets? The Hedge America trade might indicate that the process has begun or that it is only temporary, but it does not answer these questions.

It might be useful to reference erratic policymaking in emerging markets where this process is well-advanced and compare it with the recent US episode. **Figure 5*a*** depicts the USD-EUR exchange rate around the time of key announcements in the United States that signaled policy uncertainty. When it was hinted that the president would demand rate cuts or that the administration could start a cryptocurrency reserve, these announcements were seen as signs of policy uncertainty by markets, resulting in the depreciation of the US dollar. **Figure 5*b*** depicts the TRY-USD exchange rate in 2018, when several announcements signaled to markets that Turkey's central bank would no longer follow orthodox monetary policy. The uncertainty around the future of monetary policy saw the country's currency depreciate around these announcements.

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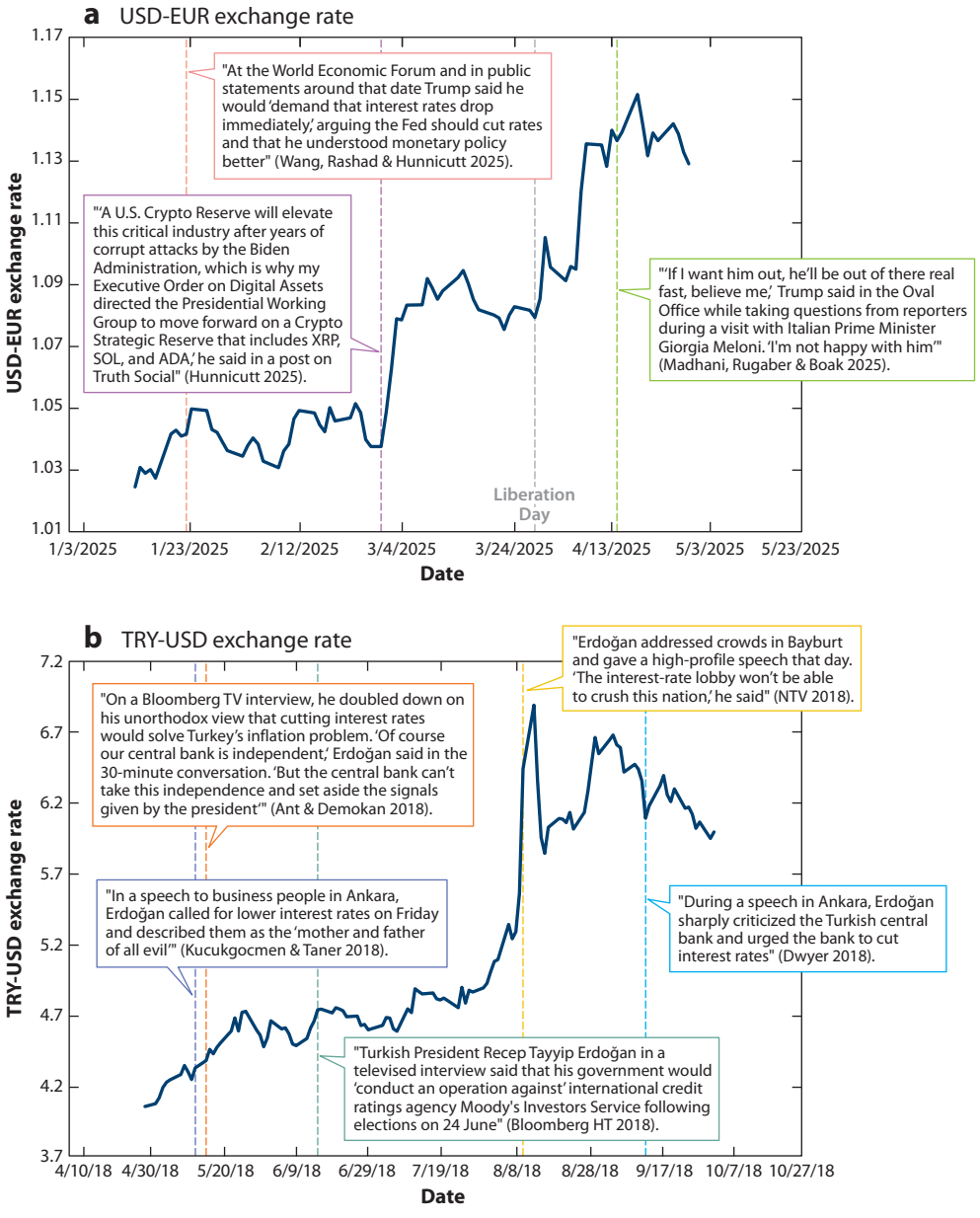

Figure 5

Policy announcements and the exchange rate. Panel *a* shows the USD-EUR exchange rate, January–May 2025, around four US policy announcements: the Davos demand for immediate rate cuts (January 23), the Truth Social crypto-reserve post (March 2), the Liberation Day tariffs (April 2) (Executive Office of the President 2025), and remarks on removing the Fed chair (April 17). Panel *b* shows the TRY-USD exchange rate, April–October 2018, around five speeches and interviews in which President Erdoğan challenged central-bank independence. Data from FRED exchange-rate series. Abbreviations: EUR, euro; FRED, Federal Reserve Economic Data; TRY, Turkish lira; USD, US dollar.

Episodes of policy volatility such as these require further attention with high-frequency identification methods to isolate the impact of uncertainty from the impact of fundamentals on levels for the nominal interest rates. These types of shocks additionally invite new modeling approaches in the open-economy context that explore the impact of second-moment policy volatility shocks. As an example, Kalemli-Özcan, Soylu & Yıldırım (2026a) demonstrate how tariff policy uncertainty, as a second-moment shock, can generate depreciation of the US dollar in a two-country version of the global general equilibrium network model of Kalemli-Özcan, Soylu & Yıldırım (2025), in spite of the appreciation pressure coming from the level of tariffs (first-moment shock).

7. CONCLUSION

Credible, predictable policymaking directly lowers the cost of external financing, regardless of the currency in which this financing is denominated. Governments that maintain clear communication and avoid abrupt interventions reduce the currency risk premium demanded by global investors on local-currency debt borrowed in international markets. These patterns are well-documented for emerging markets, where data on survey-based exchange rate expectations reveal that investors price policy risk rationally and in a forward-looking manner. The persistence of positive expected currency risk premia compensates for volatility in local policy regimes.

We show similar results for the world's most liquid and safe currencies, the British pound and the US dollar. Around certain events characterized by erratic policymaking, these currencies behaved like emerging market currencies: They depreciated against the euro, and this depreciation persisted, feeding into higher currency risk premia (UIP premia) in the short term, together with expected appreciations and higher bond yields. Such findings bridge the gap between macroeconomic fundamentals and financial market risk pricing, recasting the UIP puzzle as a reflection of governance (or competence) risk that links to future loss of value of certain assets. The findings call for models of open-economy asset pricing where heterogeneous, time-varying local policy risk interacts with global financial conditions. Simple representative-agent UIP frameworks, or exogenous shocks to UIP or intermediation, do not by themselves capture the relevant phenomena. Incomplete financial markets, heterogeneous investors in terms of their risk attitudes toward different country/currency bonds combined with heterogeneous beliefs, and endogenous issuance responses are important ingredients. Future work embedding heterogeneous investor demand that is endogenous to policy credibility into open-economy models of exchange rate determination is needed.

DISCLOSURE STATEMENT

The authors are not aware of any affiliations, memberships, funding, or financial holdings that might be perceived as affecting the objectivity of this review.

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