central banks in Australia, Canada and the United Kingdom did not. Second, nominal interest rates have been declining over time: by the end of the period, we have a group of countries with zero or even negative nominal interest rates (Denmark, Switzerland, Japan, and Sweden) and countries with clearly positive nominal rates (Australia, and New Zealand). The third panel in the figure reports yearly average CIP gaps in our sample. Prior to 2007, CIP deviations were on average small and within 20bp from 0 for all the economies, a well-established fact in international finance. During the global financial crisis of 2007-2009, we have observed major deviations from covered interest rate parity for all the currencies in our sample. Interestingly, these deviations have persisted even after the financial crisis for a group of countries, most notably Switzerland, Denmark, Japan, and Sweden.

We exploit the variation in these three series, both across countries and over time, to verify two main predictions of the model. Because the deviations from CIP during the 2007-2009 period were extreme and, as discussed by Baba and Packer (2009), Ivashina, Scharfstein and Stein (2015), Du et al. (2016), and Borio, McCauley, McGuire and Sushko (2016), were due to unusually tight limits to arbitrage during the crisis, we exclude this period and split the time dimension of our sample in two subsets: before (2002-2006) and after (2010-2015) the financial crisis. The left panel of Figure 8 plots the average foreign reserve holdings to GDP ratio against the average CIP deviations in these two sub-samples. The plot shows a positive relationship, both across countries and over time, between the level of foreign reserves and the deviations from the CIP. This empirical finding, which to the best of our knowledge has not been previously noted in the literature, is consistent with the mechanism at the heart of our model, whereby the monetary authority is able to sustain a positive gap between the domestic and world real interest rate by accumulating a sufficiently large position in foreign assets. Interestingly, the relation between foreign reserves and CIP gaps is stronger in the post-crisis subsample. In light