

ABSTRACT

To ascertain whether exchange rate depreciation is a significant determinant of inflation or whether inflation is a significant determinant of exchange rate depreciation in India. The analysis of exchange rate depreciation and inflation in India is based on a data series from the year 1970 up to 2003. Inflation depends on exchange rate, money supply, real GDP, and lagged inflation. This study has used the recent autoregressive distributed lag (ARDL) bound testing procedure developed by Pesaran et al to examine the cointegration (long run) relationship between inflation and its determinants (in particular, between inflation and exchange rate). To determine the presence or otherwise of unit root as well as the order of integration of the variables in the regression, the Augmented Dickey Fuller (ADF) unit root test was employed. Series that are found to be stationary were adopted, and those found not stationary were differenced to make them stationary. We first test for the null hypothesis of no co integration (long-run relationship) against the existence of a long-run relationship between inflation, exchange rate depreciation and other explanatory variables, then, if a unique long run relationship exists among the variables of interest, we estimate a conditional ARDL long run model for inflation rate. In the third and final step, we obtain the short run dynamic elasticity estimates.

The results show that inflation in India is not responsive to exchange rate depreciation.