ABSTRACT

Theoretical literature suggests that there exist a logical relationship between real exchange rates and real interest rate differential in economy particularly when cointegration technique is used. In particular we review voluminous literature that tests for a unit root in real exchange and the closely related working for a unit root in the residual from the regression of the real exchange and real interest rate differential. This paper also investigates for spurious the reason for no cointegration between the variable. We use data of India and U.S. to empirically examine the prediction of the purchasing power parity and interest rate parity theories. The results show that the two variables are not cointegrated. This form of relationship however, does not according exactly with a tradition representation of the long-run exchange rate, and we offer some potential explanation.

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Author’s E-mail Address: aedeepak@mse.ac.in