

Exchange Rate and Interest Rate Linkage: the Validity of Uncovered Interest Parity (UIP) in Sri Lanka.

Champika Dharmadasa

(Faculty of Science & Engineering, Saga University, Japan)

Abstract

The objective of this paper is to examine the link between interest rates and exchange rates in Sri Lanka under the framework of uncovered interest rate parity (UIP) hypothesis between the periods from January 1990 to December 2011. To explore the validity of UIP hypothesis in the Sri Lankan setting, the paper used three foreign financial markets to utilize three bilateral exchange rates namely US Dollar, Japanese Yen and Indian Rupee which are defined by the domestic price of foreign currency and three types of short term (with three month maturity) interest rates that are denoted by interbank call money rates, treasury bills rates and discount rates for India, US and Japan respectively. Generalized Method of Moment (GMM) estimation is used as the main estimation technique of the paper and prior to that several other tests were carried out including co-integration test and a test on excess returns. Empirical results revealed that the coefficient of interest rate differentials is significant with a negative sign in all cases which in turn implies the UIP condition does not hold in Sri Lanka within the given time frame. The implication drawn from the study therefore is that interest rate differential is a poor predictor of exchange rate yields and the consideration of other possible policy variables under long time span along with interest rate differentials would be advantageous to obtain more accurate results.

JEL classification: E43, E44, F30