

Expected Purchasing Power Parity and Budget Imbalances: Modelling the Euro And the Rupee Exchange Rates

Bala Batavia¹
Parameswar Nandakumar²
& Cheick Wague³

¹ Professor,
DePaul University, 1, E. Jackson Blvd (DPC 6200), Chicago, Ill. 60 604
USA (email: bbatavia@depaul.edu)

² Professor,
Indian Institute of Management Kozhikode, Kozhikode – 673 570
(Corresponding Author) (email:nanda@iimk.ac.in)

³ Professor,
Sodertorn University of Stockholm, 14189, Stockholm.

An expected relative PPP model, augmented by elements of a monetary model and by external influences, is used to track the path of the Euro-Dollar rate since the inception of the European currency. A similar model is also applied to the estimation of the Rupee – Dollar exchange rate. Expected inflation rates, based on a specified formation process, are, indeed, seen to be significant determinants of the Euro exchange rate. While money supplies are not significant, interest rate differentials do matter; higher real Euro area interest rates appreciate the Euro. US government budget deficits appreciate the Dollar with a lag, presumably due to financing capital inflows, but current account deficits do not have a perceptible influence in the period of the study. Oil price increases and higher international reserve holdings in major Asian markets, which may be skewed towards the dollar, also have no discernible impact on the Euro-Dollar rate. For the rupee – dollar rate, interest rate differentials and inflation differentials work well as predictors. Higher interest rates relative to the global rates appreciate the rupee, i.e., the rupee – dollar rate falls. Higher expected inflation in India depreciates the rupee. Current account surpluses are seen to appreciate the rupee, but investment inflows function poorly as a predictor. A random walk model may work as well as a formal monetary – PPP model in forecasting the rupee exchange rate.

*For further details, contact - Publications & Research Dissemination Office, IIMKozhikode,
IIMK Campus PO – 673 570, Kozhikode, Kerala, India. Phone: (91) 0495 2809126
Email:prd@iimk.ac.in.*
