Applicability of Uncovered Interest Rate Parity: Evidence from Sri Lanka

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The purpose of this research is to examine the validity of the Uncovered Interest rate Parity (UIP) theory in Sri Lanka. UIP theory states that, under rational expectations, the rate of depreciation of local currency should be precisely equal to the difference between the domestic and the foreign-risk free interest rate. This research examines the validity of the UIP condition in both long-run and short-run dynamics applying the Autoregressive Distributed Lag cointegration approach (ARDL) for Sri Lanka. Optimum lag order is observed using all possible Goodness of fit tests and a maximum of 8 lags. The results obtained through the ARDL and VECM model shows that the Exchange rate returns has a significant positive impact on the Interest rate in both short run and long run for Sri Lanka. Hence, it can be concluded that Exchange rate returns has a positive impact on the Interest rate which validates the Uncovered Interest rate Parity (UIP) theory in Sri Lanka.

Keywords: *Autoregressive distributed lag, Exchange rate differential, Interest rate differential, Uncovered interest rate parity*

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