

The Impact of Interest Rate in Determining Exchange Rate: Revisiting Interest Rate Parity Theory

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The objective of this study is to examine the relationship between Interest rate and the Exchange rate and to find the effect of changes in Interest rate on Exchange rate volatilities. Exchange rate is sensitive to number of factors, where Interest rate is identified as a major factor (Ozun & Cifter , 2010). Central Bank of Sri Lanka provides quantitative evidence for the study, where Sri Lanka Inter-Bank Offer Rate (SLIBOR) constitutes the independent variable and US Dollar to Sri Lankan Rupee exchange rate represents dependent variable. Sample spreads through 4 years and contains daily data. Data set is proven to be normally distributed. Correlation and Linear Regression Model is used to ascertain relationships. Results of the study are consistent with Interest Rate Parity theory that discloses a strong positive relationship between Interest rate and Exchange rate. This study extends the literature on international financing and provides valuable information to decision makers in small open economies and to the academia.

Keywords: Interest Rate, Exchange Rate, Central Bank of Sri Lanka, Exchange Rate Parity

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