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PAPER

Applicability of Purchasing Power Parity (PPP) in Sri Lankan Context

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The purchasing power parity (PPP) hypothesis can be regarded as the cornerstone of many of the theoretical models of international finance. Testing for the long-run PPP hypothesis provides a useful insight about the competitiveness between a country and its trading partners. Many studies could be found testing the long-run PPP hypothesis but only few studies could be found on PPP in the Sri Lankan context and there is no evidence of research using data of the 21st century.

In this paper the researcher has attempted to check the absolute and relative PPP in Sri Lanka in terms of trading partners and competitors. As trading partner currencies the researcher has used USD, GBP, Yen, and Yuen because they are the main contributors of Sri Lankan imports. As competitor currencies researcher has used INR and Baat because they have been the main competitors for the Sri Lankan apparel exports.

According to the absolute PPP theory if the PPP holds between both countries the exchange rate between two countries should be equal to the ratio of the general price levels of the two countries. If relative PPP holds, the percentage change in the exchange rate between two countries over any period should be equal to the difference between the percentage change in national price levels.

In order to examine the validity of the absolute and relative PPP hypothesis, the researcher has first checked the nominal exchange rates from January 1986 to December 2009 with the use of Cointegration method and Wald test. Then the real exchange rates with the use of ADF Unit root test were checked.

Based on the test results, it can be concluded that even though the absolute PPP may not hold, the relative PPP may hold in Sri Lanka from 1986 to 2009 for the above trading partners and competitors. The objective of this research was not only to validate the PPP as the main determinant of the exchange rate but to understand which factors may influence not holding the PPP in the Sri Lankan context.