RELATIONSHIP OF EXCHANGE RATE WITH VARIOUS MACRO ECONOMIC VARIABLES

Mushtaq ur Rehman
Mohammed Ali Jinaah University, Islamabad

Shafiq ur Rehman
Mohammed Ali Jinaah University, Islamabad

ABSTRACT
This paper investigated some of the Past Literature on Exchange rate, its aim is to provide that why Pakistani currency is more sensitive and devalue quickly in exchange with other currency specially US dollar. This paper presents the empirical evidence on purchasing power parity (PPP) for [Pakistan rupee vis-avis US dollar exchange rate. We find a considerable support for the existence of long run PPP. Further more the result of error-correction suggest that nominal exchange rate plays an important role in the eliminating deviations from long run PPP. the result further suggest that there is high degree of foreign exchange and goods markets integration. One major policy implication derived from the findings of this study that the monetary authorities should contain money supply growth in order to stabilized prices and reduce balance of payments deficits, though the study shows that there is theoretical relationship between exchange rate fluctuations and various macro economic indicators such as interest rate, inflation rate, current account and gross domestic product (GDP). Changes in interest rate, inflation rate, current account and gross domestic product affects exchange rate fluctuation. The findings of the research suggest that effects of gross domestic product over exchange rate is high in nature, the currency is devalue in exchange due to deficit GDP, and its impact is high on exchange rate followed by other variables such as inflation rate which effects is also not negioable, Followed by interest rate and current account balances.

Keywords: Exchange Rate, Inflation Rate, Interest Rate, GDP, Current Account.
* Corresponding author: Mushtaq ur Rehman Research Student (Mphil in progress) Mohammad Ali Jinnah University Islamabad Campus, Email: mushionline@gmail.com
1. Introduction

In the era of globalization and financial liberalization, exchange rate plays an important role in international trade and finance for a small open economy like Pakistan. This is because movements in exchange rates affect the profitability of Multinationals and increase exchange exposure to enterprises and financial Institutions. A stable exchange rate may help enterprise and financial institutions in Evaluating the performance of investments, financing and hedging and thus reducing their operational risks. Fluctuations in the exchange rate may have a significant impact on the macroeconomic fundamentals such as interest rates, prices, wages, unemployment, and the level of output. This may ultimately results in a macroeconomic disequilibrium that would lead to real exchange rate devaluation to correct for external imbalances (Parikh and Williams, 1998).

Purchasing power parity (PPP) is the most fundamental and controversial hypotheses in international finance through which the long-run equilibrium exchange rate can be explained. It serves as a benchmark for computing equilibrium exchange rate and assessing whether shocks to the real exchange rate dampen over time. This makes the PPP theory as an attractive theoretical and empirical tool for understanding the fluctuations in exchange rate over time.

PPP theory enjoys significance in the literature and has far-reaching Implications at the theoretical, empirical and policy levels. For example, PPP theory constitutes one of the fundamental building blocks in modeling the theories of Exchange rate determination. At policy level, it provides an important theoretical Basis for the financial stabilization and structural adjustment policies sponsored by the International Monetary Fund and World Bank. It also plays an important role in the choice between money and inflation targeting in the design of monetary policy.
PPP is also sets the criterion for judging whether the exchange rate is overvalued or undervalued in relation to its long-run equilibrium path the exchange rate is the price at which the currency of one country can be converted to the currency of another. Although some exchange rates are fixed by agreement, most fluctuate or float from day to day. An exchange rate is the current market price for which one currency can be exchanged for another. If the U.S. exchange rate for the Pakistani Rupee PKR is 83, this means that 1 American Dollar can be exchanged for 83 Pakistani rupees. Changes in exchange rates have significant effects on the profits of multinational corporations. Exchange rate changes also affect the value of foreign investments held by individual investors. For a U.S. investor owning Pakistani securities, a strengthening of the U.S. dollar relative to the rupee tends to reduce the value of the Pakistani securities because the Rupee value of the securities is worth fewer dollars. Also called foreign exchange. Price for which the currency of a country can be exchanged for another country's currency. Factors that influence exchange rate include (1) interest rates, (2) inflation rate, (3) trade balance, (4) political stability, (5) internal harmony, (6) high degree of transparency in the conduct of leaders and administrators, (7) general state of economy, and (8) quality of governance.

1 See www.Brecorder.com or www.wikipedia.com
The fixed exchange rate of the Britton Woods was abandoned in 1970s. At that times the experts and observers were unable to anticipate the high volatility of exchange rates after 1970s.

In 1973 the movement toward floating exchange regime created concerns for enterprises and financial institutions. Now exchange rates deviate largely and persistently from purchasing power parity. Since this is an area of Globalization, exchange rate fluctuation plays and important role. This role is even more important for small and open economies. Exchange rate movements affect profitability of multinationals and increases risk exposure to enterprises and financial institutions. A stable rate helps enterprises to evaluate the performance of their investments, hedging and financing and thus reduce their operational risks. Furthermore exchange rate fluctuations have a significant impact on macroeconomic fundamentals such as interest rates, inflation rates, prices, wages, unemployment and level of output. Since macroeconomics is the big picture of an economy overall performance. It is important to forecast exchange rate fluctuations.

One class of exchange rate forecasts is “random walk” forecasts. Under these forecasts all contemporaneously available information about future exchange rate movements is reflected in the current value of the exchange rate and all future events leading to future exchange rate movements are purely random from the perspective of today. A second class of exchange rate forecasts is based on linking exchange rate fluctuation to insight about price determination in financial markets from microeconomic theory. Trade on foreign exchange markets obviously is not only related to news about macroeconomic variables, but also occurs after different types of private information’s have become available to market participants. Third the exchange rate forecasts are based on” Technical analysis arrive at exchange rate forecasts by mechanically extrapolating past rate of exchange rate fluctuations into the future. For these models to consistently yield highly forecasts, exchange rate fluctuation will need to occur in sufficiently frequent and regular up- and downswings. A fourth class of exchange rate forecasts is to link predicted future exchange rate movements with predicted future movements in certain key macroeconomic variables.
There are regularly sizeable imbalances in the distribution of saving and asset holdings as well as of relative prices across countries. It stands to be expected that such imbalances will eventually be corrected and will then lead to adjustments in nominal exchange rates. Thus the second class of forecasting model aims to establish relationship between exchange rate fluctuations and certain key macro economic variables. The state of macro economic environment itself is varying over time, and the key variables mattering today may have played no more than a limited role in the past. Thus it is very subtle and challenging task to determine proper macro economic equilibrium relations, which forecast exchange rate at a specific point in time. Forecasts of exchange rate fluctuations based on certain key macro economic variables have in most economic environment performed very poorly.

When the exchange rate between the foreign currency of an international investment and the U.S. dollar changes, it can increase or reduce your investment return. Because foreign companies trade and pay dividends in the currency of their local market, you will need to convert the cash you receive from dividends or the sale of the investment into U.S. dollars. Therefore, if the exchange rate changes significantly between the time you buy and the time you sell, it can sometimes turn a positive return in the investment itself into a loss for the investment in total, or vice versa. International investment returns increase when the dollar weakens in value against another currency, because each unit of foreign currency translates into more U.S. dollars. On the other hand, if the U.S. dollar strengthens against the foreign currency, it translates each foreign currency unit into fewer U.S. dollars and therefore diminishes your returns.

In this paper researcher will explore the relationship between macro economic variables and exchange rate fluctuations in response to these variables. I will find out which macro economic variables are more closely correlated with exchange rate fluctuations. Theoretically there are preplanned relationship between macro economic variables and exchange rate fluctuations. In this paper I will find out whether these relationships hold true in practical sense or not.

2. Literature review
Jakab (1999) reported nominal rigidities do not play a substantial role in tradable real exchange rate fluctuation. Exchange rate policy is not the main sources of real exchange fluctuations. Supply shocks were the main determinants of exchange rate fluctuation. D. West (2003) reported that exchange rate fluctuation is helpful in future economic variables such as money, income, prices and interest rates. The exchange rates can help forecast fundamental macroeconomic indicators. Dong (2006) further concluded that monetary policy shocks were accounted for 90 percent deviation from UIP at a short horizon, 70 percent variance is due to interest rate and output gap and 50 percent were due to monetary shocks.

Omerbegivic (2005) has find that the appropriateness of the exchange rate is determined by the criteria whether the current level of the exchange rate that is associated with the equilibrium situation, which is defined in terms of goods and labor market equilibrium and the external balance being sustainable, which on the other hand is determined by the condition of the real economic variables found in equilibrium. Hence, a proper understanding the determinants of exchange rate helps the policy-makers to design appropriate exchange rate policy in achieving the long-run sustainability of the balance of payments.

Simon & Rajak (1999), Lahari & Hanatrovaska (2008) reported relationship between exchange rate fluctuation and changes in interest rate that there is a positive relationship between exchange rate fluctuation and interest rate. Lahari & Hanatrovaska (2008) further concluded a non monotonic relationship between changes in level of interest rate and changes in interest rate. Jakab Millhey (1999) reported that nominal rigidities do not play a substantial role in tradable real exchange rate fluctuations, exchange rate policy shocks were not the main sources of real exchange rate fluctuation.

Asana and Camille (2004) concluded that the nominal exchange rates tend to offset relative price movements. It also postulates that adjustments to parity are made via nominal exchange rate movements. This theory basically relies on the law of one price (LOP) in an integrated and competitive product market with an implicit assumption of a risk neutral world. The concept is based on a flow theory of exchange rates where the Demand for currency is to
pay for exports and the supply is to pay for imports. Despite the fact that the theory has been known for centuries, PPP remains Controversial as ever.

Binder (2000) reported that exchange rate forecasting is to link predicted exchange rate movements in certain key macro economic as money, income, prices and interest rate. Lahari & Trovask (2008), Ito & Sato (2006), have concluded that exchange rate fluctuation and changes in inflation are interrelated. Golen Benita (2001) Said That macro-economic variables affect the daily volatility of the exchange rate against the U.S. Dollar. Analyzing an international panel of 43 currencies in 1990-2001 we find that the flexibility of the exchange rate regime, central bank's intervention and the uncertainty of the domestic economy increase exchange rate volatility, while the country's economic wealth decreases volatility. Restrictions on capital flows do not affect exchange rate volatility.

The positive correlations of real interest rate and central bank's intervention with the exchange rate volatility that we found in the panel data may be due to a cross-country difference. Countries with higher exchange rate volatility routinely employ higher real interest rates and more central bank intervention in order to control exchange rate volatility. Conway, Drew, Ben haunt and Alasdair (1998) concluded that changes in exchange rate causes more changes in inflation rate. Branson (1981) reported that real exchange rates adjust to real disturbance in the current account and the time series seem to signal the need for adjustment. Obstfield & Rogoff (2005), Araki (2001), Anderson (2005), Kendal (2004) concluded a substantial relationship between exchange rates fluctuation and current account balance. Nelson & Kara (2002) reported that correlation between CPI inflation and exchange rate changes was little.

Lahrèche-Révil (dec 2001) in this paper. First, the Researcher discuss real exchange rate is likely to be an increasing concern for both trade and foreign direct investment. Second, exchange-rate volatility is also shown to play a role for attracting FDI, but we were unable to evidence an influence of exchange-rate uncertainty on trade. Third, the simulations show that exchange rate has little economic incentive to push for regional monetary cooperation, at least on the two grounds of trade and FDI, whereas the reverse is not true: other emerging countries in East-Asia may loose from a domino-style cascade of devaluations and depreciations.
Sadeghi, Samson & Sherafat (2007) concluded that a one percent increase in exchange rate causes 10 percent increase in inflation rate. Hajhouj (2000) have concluded that when exchange rate fluctuations rise, firms shift investment from the foreign markets to domestic markets. He also noted that when prices and wages move in the same direction, international firms are enhanced to increase its capital. Schmidt (2001) reported a positive relationship between home currency depreciation and FDI outflows. He reported statistical significance for all industries except electric machinery.

Kendal (2004) further reported that depreciation of the currency leads to increase in real output. Rosengren, Eric (1992) reported that there has been a significant correlation between inward foreign direct investment in the United States and the US real exchange rates since 1970. Two alternative reasons were responsible for that. Real exchange rate affect relative cost of production and relative exchange rates affect the relative wealth significantly across countries. He also noted that relative wealth significantly affects foreign direct investment in the united state and the effects of real wages have little impact on FDI. Arizonan (1992) have concluded that nominal shocks in flexible exchange rate regimes have adverse implications on investment behavior and a fixed exchange rate encourage FDI.

3. Purchasing power parity a theoretical model

PPP is generally attributed to Cassell’s writings in the 1920s, although its intellectual origins date back to the early writings of the 19th century British economist David Ricardo (1821). The basic concept underlying the PPP theory is that goods market arbitrage equalizes prices internationally once the prices of goods are measured in the same currency (Pilbeam, 1998). PPP continuously serves as an equilibrium condition in the theory of exchange rate determination and in exchange rate policy and frequently used to determine the link between exchange rate and relative prices. The building block of PPP is the law of one price (LOP) which simply states that in the absence of a competitive market structure and the absence of transport costs, quotas, tariffs and other trade impediments, trade and effective arbitrage in goods markets should ensure identical price across countries. The LOP is based on the idea of perfect goods
Arbitrage occurs where economic agents exploit price differences to provide a risk less profit. The proponents of PPP argue that the exchange rate must adjust to ensure that the LOP holds internationally for identical bundle of goods. The testable version of absolute PPP is given by:

\[ s = \beta_0 + \beta_1 (p - p^*) t + \epsilon \]

Where \( s \), \( p \) and \( p^* \) are the natural log of nominal exchange rate, domestic and foreign price indices respectively while \( \epsilon \) is the error term. This version of PPP states that the price of a common basket of goods in the two countries will be the same at all time because of costless spatial arbitrage. In equation (1), \( \beta_0 \) is the logarithm of the exchange rate observed in the base period.

The absolute PPP theory states that an increase in the domestic price level due to monetary expansion or unrestrained credit expansion should result in equal proportionate depreciation of the nominal exchange rate. This proposition holds true only when \( \beta_0 = 0 \) and \( \beta_1 = 1 \). Furthermore, real factor also affect the common basket of goods measured in a common currency. However, \( \beta_0 = 0 \) is often relaxed due to the presence of transportation costs, official intervention in the foreign exchange markets and other possible impediments to trade. The restriction \( \beta_1 = 1 \) can also be relaxed due to the measurement errors. In addition, national price levels and the nominal exchange rates are generally found to be non-stationary so that the estimated coefficients in equation are biased and do not have a usual distribution. For these reasons, co integration tests of PPP do not usually impose restrictions on the values of the coefficients appearing in equation. However, in the real world the equilibrium price of a good may not be the same when converted into a common currency.

The reason for this includes the wedge between price levels across countries is created because of transport costs, asymmetric information and the distorting effects of tariffs and other forms of protectionism, which reduce the effectiveness of arbitrators. In addition, the presence of non-traded goods can prevent arbitrators from responding to profitable investment opportunities. The non-traded neutrality of money in the short-run can generate price differences
in similar goods across countries. This price heterogeneity does not imply the market failure, but it may simply reflect the inability to shift the commodities costless and instantaneously from one location to the other. It is argued that a weaker form of PPP - known as relative PPP can be expected to hold even in the presence of such distortions the testable version of relative PPP is given by

\[ \Delta = a_0 + \Delta a_1 - (? p - ? p^*) + e \]

Where \( \Delta \) is the first difference operator. For the relative PPP to hold the coefficient restrictions \( a_0 = 0 \) and \( a_1 = 1 \) must not be rejected. If these restrictions hold then relative PPP argues that the rate of change in exchange rate is equal to the inflation.

Differential among two countries. The absolute PPP in equation shows comparative prices in different currencies in a given location and common basket of identical goods. Due to the fact that the PPP hypothesis is regarded as a theory of exchange rate determination, hence, its validity may be depends on the degree of the exchange rate flexibility. The absolute PPP cannot be tested empirically due to the non-availability of Comparable data, particularly, on the price levels across countries. However, Bhatti (1996) has pointed out that the distinction between absolute and relative PPP becomes practically impossible because the domestic and foreign price levels are inevitably measured in relative terms by assuming unit price in some base year.

4. Methodology

The research uses simple linear regression equation in order to explore the causal relationship of exchange rate represented by \( Y \) with the Interest Rate, Inflation Rate, Current Account Balances and GDP represented by \( X \)'s. The simple regression equation is as under:

\[ Y = a + \beta X + e \]

Where \( Y \) is the dependent variable, i.e., Exchange Rate and \( X \)'s are the independent variables, i.e., Interest Rate, Inflation Rate, Current Account Balances and GDP. Here \( ? \) represents 1, 2, 3, 4 and 5 respectively for the above independent variables. Where \( a \) and \( \beta \) are the population parameters, \( a \) is the intercept and \( \beta \) is the regression coefficient, respectively. The \( e \)'s are error components or random deviations and are estimated by \( e \)'s. The intercept and regression coefficient are, i.e., \( a \) and \( \beta \), are estimated from sample data through using the following formulas;
\[ a = \frac{(\sum X^2 Y) - (\sum X \cdot X \cdot Y)}{n \cdot (\sum X^2) - (\sum X)^2} \]

\[ b = \frac{n \cdot (\sum X \cdot Y) - (\sum X \cdot Y)}{n \cdot (\sum X^2) - (\sum X)^2} \]

5. Table of Data

<table>
<thead>
<tr>
<th>Years</th>
<th>Exchange Rate (Y)</th>
<th>Interest Rate (X_1)</th>
<th>Inflation Rate (X_2)</th>
<th>Current Account (X_3)</th>
<th>GDP (X_4)</th>
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<td>39.99</td>
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<td>10.8</td>
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<tr>
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<td>11.8</td>
<td>-4348</td>
<td>2677656</td>
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<tr>
<td>1992</td>
<td>46.79</td>
<td>12.14</td>
<td>7.8</td>
<td>-3557</td>
<td>2938379</td>
</tr>
<tr>
<td>1993</td>
<td>51.77</td>
<td>9.83</td>
<td>5.7</td>
<td>-1701</td>
<td>3826112</td>
</tr>
<tr>
<td>1994</td>
<td>58.44</td>
<td>9.83</td>
<td>3.6</td>
<td>-1856</td>
<td>4209873</td>
</tr>
<tr>
<td>1995</td>
<td>61.43</td>
<td>8.96</td>
<td>4.4</td>
<td>-217</td>
<td>4452654</td>
</tr>
<tr>
<td>1996</td>
<td>58.5</td>
<td>6.18</td>
<td>3.5</td>
<td>326</td>
<td>4875648</td>
</tr>
<tr>
<td>1997</td>
<td>57.57</td>
<td>2.7</td>
<td>3.1</td>
<td>2723</td>
<td>5640580</td>
</tr>
<tr>
<td>1999</td>
<td>59.34</td>
<td>2.84</td>
<td>4.6</td>
<td>4070</td>
<td>6499832</td>
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<tr>
<td>2000</td>
<td>59.86</td>
<td>5.83</td>
<td>9.3</td>
<td>1811</td>
<td>7623205</td>
</tr>
</tbody>
</table>
6. Exchange Rate VS Interest Rate

Whenever the interest rate rises return on investment increases to investors both for private and public investors. When interest rate raises the country currency appreciates. The main reason behind this appreciation is that more and more people come inside the county and invest more and more. This inflow of investors increases the demand for the recipient country and the supply of the foreign currencies increase as compared to that of the home currency.

The demand pressure will appreciate the home currency. Here we have analyzed the effects of interest rate over the exchange rate fluctuation. The regression coefficient R here is 64.1%. It means that there is a high relationship between exchange rate fluctuation and the interest rate. The coefficient of determination i.e. $R^2$ here is 41.1%. It means that 41.1% of exchange rate fluctuation is caused by the interest rate changes.

<table>
<thead>
<tr>
<th>Model</th>
<th>R</th>
<th>R Square</th>
<th>Adjusted R Square</th>
<th>Std. Error of the Estimate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>.641(a)</td>
<td>.411</td>
<td>.375</td>
<td>11.56999</td>
</tr>
</tbody>
</table>

Sources: Asian Development bank, State bank of Pakistan
Histogram

Dependent Variable: exhangerate

Regression Standardized Residual

Frequency

Mean = 5.27E-16
Std. Dev. = 0.97
N = 18
7. Exchange Rate and Inflation

When the inflation rate of a country increases the currency depreciate because inflation is inversely related to that of the value of currency. When the inflation increases both public and private investors expropriate their profits from the investing countries. The home country residents also adopt such practice. This will again increase the demand for the foreign currency and the home currency demand will decrease. The home currency will be sold and the foreign currency will be bought. The selling pressure will depreciate the home currency and the buying pressure will appreciate the foreign currency. In our analysis the regression relation between the exchange rate fluctuation and the inflation is 65.4%. This relationship is very high. It means the inflation is very important to influence the exchange rate fluctuation. The coefficient of determination i.e., $R^2$ is 42.8% that means that 42.8% of exchange rate fluctuations is caused by changes in inflation rate.

8. Exchange Rate and Current Account Balance

There is a theoretical relationship between the exchange rate and the balance of the current account. When there is a surplus balance in the current account the home currency appreciates while in case of the deficit in the current account the home currency depreciates. In this research we are interested in the effects of inflation rates upon exchange rate fluctuation. The findings of
the research is as under; R=45.5%. it means the relationship between current account and exchange rate fluctuation is not very high. Coefficient of determination is 11.9% i.e. only 11.9% percent of the exchange rate fluctuation is caused by the changes in the current account.

<table>
<thead>
<tr>
<th>Mode</th>
<th>R</th>
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<th>Adjusted R Square</th>
<th>Std. Error of the Estimate</th>
<th>Change Statistics</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>.345 (a)</td>
<td>.119</td>
<td>.064</td>
<td>14.1577</td>
<td>.119</td>
</tr>
</tbody>
</table>

9. Exchange Rates and Gross Domestic Product

Theoretically the gross domestic product and the exchange rate are related. When the gross domestic product increases it decrease the home currency depreciation. So the gross domestic product is influencing the exchange rate fluctuation. The findings of the research are as under; R=84.4%, it means that the relationship between the exchange rate fluctuation and the gross domestic product (GDP). The coefficient of determination i.e. R2 is 71.1%. It means that
71.1% changes in exchange rate fluctuation is caused by the changes in the gross domestic product.

<table>
<thead>
<tr>
<th>Model</th>
<th>R</th>
<th>R Square</th>
<th>Adjusted R Square</th>
<th>Std. Error of the Estimate</th>
<th>Change Statistics</th>
<th>F Change</th>
<th>df1</th>
<th>df2</th>
<th>Sig. F Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>.844(a)</td>
<td>.713</td>
<td>.695</td>
<td>8.08654</td>
<td>.713</td>
<td>39.652</td>
<td>1</td>
<td>16</td>
<td>.000</td>
</tr>
</tbody>
</table>

10. Conclusion

The research findings are summarized as under; interest rates, inflation rate, current account, real interest rate and gross domestic products have important role in the exchange rate fluctuation. The results in the Pakistan economy context are as under; among all these variables the most important is the gross domestic products which have correlation coefficient of R= 84.4% and with 71.1% of coefficient of determination. Next the inflation rate is more influencing the exchange rate fluctuation. The coefficient of correlation R is 64.1% while the coefficient of determination i.e. R2 is 42.8% while the coefficient of determination. Next the relationship between interest rate and the exchange rate fluctuation is R= 64.1% while the coefficient of determination i.e. R2 is 41.1%. The effects of current account on exchange rate fluctuations is very low as compared to the above four determinants of exchange rate. The coefficient of correlation is i.e R=34.5% and the coefficient of determination i.e $R^2 = 11.9%$. it means that exchange rate fluctuations is caused only by 11.9 % by changes in current account
while the rest of the changes that is 99.1% changes are caused by some other factor. Thus the effects of GDP over exchange rate fluctuation are high, and the effects of current account are very low.

The co integration coefficient between nominal exchange rate and the WPI-based price ratio is close to unity, confirming the proportionality proposition. These results lend strong support for the validity of WPI-based PPP. The reason for the presence of PPP in the traded sector could be: (i) the economic development of Pakistan is heavy dependent on the developed countries, and (ii) the government is pursuing trade, finance and exchange rate liberalization policies since 1990. To this end, various price controls were lifted and significant efforts were made in liberalizing the trade and payment systems. These liberalization policies allowed the LOP to work more efficiently as shown by the supportive evidence of PPP. The results further implies that high inflation rate due to monetary shocks have been neutralized over the long-run. Second, the validity of PPP indicates a higher degree of goods and foreign exchange markets integration. The short-run deviation from PPP has frequently occurred, but the long-run validity of PPP could not be rejected. An error-correction term is negative and significant. The size of the error-correction term is small indicating that the speed of adjustment towards long-run equilibrium is rather slow. Third, economic reforms helped to increase the flexibility of prices and nominal exchange rates in adjusting the short-term deviations and shortened the time span required for dampening these deviations.

The findings confirm WPI-based PPP as a long-term anchor; namely, nominal exchange rate will tend to adjust to inflation differentials. If the monetary authorities wish to stabilize domestic prices and reduce balance of payments deficits, then monetary growth should be contained. High degree of integration between foreign exchange and goods markets unable the monetary authority to run monetary policy independently. Depreciation of exchange rate further weakening the strength of Pak Rupee. Empirical findings for developed countries suggest that the time period required for reestablishing PPP is shorter under floating exchange rate regimes; in this case, deviations from PPP could have a half-life as short as three to four years.
REFERENCES


