

## **PURCHASING POWER PARITY AND INTEREST RATE PARITY:**

### **AN EMPIRICAL STUDY OF THREE EMU COUNTRIES**

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#### **Abstract**

This study applies the Purchasing Power Parity (PPP) theory and the Uncovered Interest Rate Parity (UIP) theory to analyse the long-run equilibrium in the foreign exchange market. We study the cases of Portugal and Spain in relation to Germany and Portugal relative to Spain, during the period of 1960 to 1999. In this manner we tried to evaluate the foreign exchange market operation of two countries without a dominant currency but with organized financial markets, after the 80's, comparatively to that of a country with world markets.

The application of the referred theories to time series of different periodicity was based on the accomplishment of unit roots tests and the obtainment of cointegration relations using the Johansen methodology. The unit root analysis of the utilized series was done with the Augmented Dickey-Fuller (ADF) tests.

We were able to explore linear long-run relations based exclusively on the PPP theory, we also tested the UIP and finally we included the interest rates while explanation of the errors of the long-run relation implied in the PPP theory. Faced with the rejection of the PPP theory one could think that the agents believe, by some form of "natural reason of order", that as time goes by the dominant currency, which is also the reference currency of the EMS, will valorize in relation to the other currencies. It was concluded, on the contrary, that the weak currencies, which are not traditionally used in the international commercial relations, were the ones that with the passing of time suffered a real appreciation.

The application of these theories to two of the economies belonging to the group of southern EU countries still deserves a special attention. This is due to the fact that they can serve as an example to other countries, which in the near future might find themselves in a similar situation to that of Portugal and Spain, before their adhesion to the EU.

JEL Classification: F31, F41, C32, G15, C51

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