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CO-INTEGRATION TESTS OF EXCHANGE RATE PARITY CONDITIONS AND A MONETARY MODEL OF EXCHANGE RATE: EVIDENCE FROM THE CZECH REPUBLIC, HUNGARY, POLAND, AND SLOVAKIA[1]

Abstract: *Purchasing power parity and uncovered interest rate parity conditions are both an important building block of any modern approach towards the theory and modelling of exchange rate behaviour. Empirical analyses for these conditions across developed and "stable" economies render mixed results. An interesting question to ask is whether and to what extent the exchange rate behaviour is in accordance with these conditions in emerging foreign exchange markets. In addition to testing the conditions themselves, the paper also tests the relationship between exchange rates on the one hand and interest rates and rates of inflation on the other hand within the context of a basic monetary model of exchange rate. Regarding the time series properties required for testing the parity conditions, co-integration and vector error correction model are acceptable. The focus in this paper is laid on the most developed non-euro (by the end of 2008) countries which entered the European Union in 2004.*

Key words: *co-integration, monetary model, purchasing power parity, uncovered interest rate parity, VECM*

JEL: E 44, F 41, C 32

A substantial number of both pure theoretical or rather empirical models of both nominal and real exchange rate can be found in economic literature. One of the key building locks of most of them is the conditions of purchasing power parity or interest rate parity or both. The paper presents tests of whether the long-term relationships implied by these theories are in compliance with the data. The purchasing power parity and uncovered interest rate parity are also used within traditional monetary models of exchange rate, which is also tested in this paper.

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