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Title: Linearity and Stationarity of South Asian Real Exchange Rates

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Abstract

The linearity and stationarity of the real exchange rates of India, Nepal, Pakistan and Sri Lanka are investigated using formal linearity and the recently developed nonlinear stationary test procedures. Results obtained show that these real exchange rates are stationary albeit the presence of nonlinearity.

JEL Classification: F31, N15, C52

***Key Words*:** Nonlinearity; Real exchange rates; South Asia; linearity test; nonlinear stationary test

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Linearity and Stationarity of South Asian Real Exchange Rates

1. Introduction

Numerous documentations on the findings of nonlinearity in the exchange rates have been recently added to the existing established exchange rate study. Micheal *et al*. (1997), Sarantis (1999), Taylor and Peel (2000), Baum *et al*. (2001) and Peel *et al*. (2001), are among some of the recent articles reporting the existence of nonlinear exchange rate behaviour in the context of developed nations. Earlier on, Peel and Speight (1996) have detected nonlinearities in the exchange rate of East European countries. In a separate endeavour, Ma and Kanas (2000) found nonlinearities from those countries under Exchange Rate Mechanism. Sarno (2000a, b), on the other hand, documented the presence of nonlinearity in the real exchange rates of Middle East and highly inflation countries. Of late, Liew *et al*. (2003, 2004) and Liew (2004) found strong evidence of nonlinear behaviour of US dollar as well as Japanese yen based real exchange rates in the Asian region. This is followed by Anuruo *et al*. (2006) complement the literature by offering empirical evidence of nonlinear real exchange rates from the African continent.

One important implication of these documentations is that linear testing frameworks may no longer be taken for granted as adequate tools in the study of exchange rate. Another equally crucial implication is that linearity property of exchange rates, which has been neglected in the past, partially due to ignorance of the plausible presence of nonlinearities and partially due to the unavailability of advance information and computer technology, must be predetermined using formal linearity test prior to the