

# THE REAL INTEREST RATE DIFFERENTIAL: INTERNATIONAL EVIDENCE BASED ON NON-LINEAR UNIT ROOT TESTS

*Ahmad Zubaidi Baharumshah,\* Venus Khim-Sen Liew†  
and Chan Tze Haw‡*

\*Department of Economics, Faculty of Economics and Management,  
Universiti Putra Malaysia Selangor, Malaysia, †Labuan School of  
International Business and Finance, Labuan International Campus,  
Universiti Malaysia, Sabah, Malaysia, and ‡Faculty of Business and Law,  
Multimedia University, Melaka, Malaysia

## ABSTRACT

This paper aims at testing international parity conditions by using non-linear unit root tests advocated by Kapetanios *et al.* (2003, KSS). Results from the KSS tests based on 17 countries (G7 and 10 Asian countries) overwhelmingly show that the adjustment of real interest rates towards real interest rate parity (RIP) follows a non-linear process except for the Taiwan, Hong Kong and Philippines relationships with both the USA and Japan. Overall, the empirical results are in favour of RIP using the USA and Japan as the centre countries but only if non-linearities are accounted for in the data-generating process. Our findings confirm that interest rate differentials, like the real exchange rates reported in recent literature, display a non-linear mean reversion process.

*Keywords:* non-linearities, real interest parity, unit root tests

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Correspondence: Ahmad Zubaidi Baharumshah, Department of Economics, Faculty of Economics and Management, Universiti Putra Malaysia, 43400 UPM, Serdang Selangor, Malaysia. Tel: +603 8946 7744/7579; Fax no: +603 7946 7665; Email: zubaidi@putra.upm.edu.my. The first author acknowledges partial financial support from the Ministry of Higher Education for the Fundamental Research Program (Grant No. 06-02-03-054J). The authors are also grateful to the editor and two anonymous referees for their valuable comments and suggestions. The usual disclaimer applies.