

## **Test of Uncovered Interest Rate Parity for Sri Lanka: Evidence from LKR/GBP Rate**

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Interest rates and exchange rates are considered to be one of the most discussed areas under International Finance. When considering the main theories that explore on these two variables, Uncovered Interest Rate Parity (UIP) states that the interest rate differential is an unbiased predictor of the spot exchange rate changes. The impact on investors' attitude is that they would be indifferent towards the returns on domestic and foreign assets denominated in same currency thereby eliminating any short term arbitrage profits. Studies based on the relationship between these two variables are rare for developing countries like Sri Lanka. Therefore in order to bridge that gap identified through search for literature, this study is focused on testing UIP for Sri Lanka. Monthly data on LKR/GBP exchange rate for the period from 2001-2014 and three month interest rate for the two countries, were used for this purpose. Autoregressive Distributed Lags method was employed to test the UIP. The findings reveal that there is no evidence to prove the existence of the UIP for the selected currency compared against the Sri Lankan Rupee.

**Keywords:** Autoregressive Distributed Lags (ARDL) Model; Exchange Rates; Interest Rates; Uncovered Interest Rate Parity (UIP)