

The real uncovered interest parity: The case of Canada and the USA

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Abstract

The aim of this paper is to re-assess the real uncovered interest parity (RUIP) in the light of including *domestic* demand shocks as possible determinants of the real exchange rate. We use annual data for two close trading partners, namely Canada and the USA. Using cointegration analysis we find evidence in favour of RUIP. In addition, empirical support is provided to show that discretionary fiscal policy actions have a spillover effect to the real exchange rate *via* real interest rates.

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1. Introduction

The real uncovered interest parity (RUIP) has been a subject that has attracted considerable attention in the literature with studies focusing on *external* demand shocks as possible determinants of the real exchange rates.

This paper approaches the issue, from a different perspective. We re-assess the RUIP, i.e., the relationship between the real exchange rate and real interest rate differential, in the light of including *domestic* demand shocks as possible determinants of the real exchange rate. Obstfeld (1985) provides the theoretical rationale for including aggregate internal demand shocks, and in particular fiscal variables. He shows that “*the real exchange rate depends not only on the*

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current state of aggregate demand at home and abroad, but also on the entire expected path of aggregate demand” (p. 393). Thus even an anticipated contractionary fiscal policy at home leads to a real depreciation today by increasing real current and expected interest rate differentials. Based on this argument, we extend the empirical specification of the RUIP to allow for the structural deficit or the cyclically adjusted deficit (CAD). With CADs one can distinguish the discretionary element in fiscal policy from the component of the budget balance that reflects fluctuations in economic activity. By removing this self-correcting cyclical component from the budget deficit one can obtain a better indication of the medium-term (a horizon of three to five years) fiscal stance.

It has been well recognized that the use of the CAD is better suited when the medium-term fiscal stance is examined or when medium term objectives, for an economy, are set. This measure takes into account the volatility of a country’s economy (as evidenced by the evolution of the output gap) and the sensitivity of the budget balance (deficit or close-to-balance or surplus) to the cycle.¹ This, in turn, implies that the impact of fiscal variables on the medium-term real interest rates, and thus on the real exchange rate, is likely to be better unveiled in the proposed formulation of RUIP. In contrast, short-term rates, that have previously been used in many RUIP empirical studies, are inappropriate in the proposed formulation as they often reflect monetary policy, and thus may deviate substantially between countries, possibly for long periods, if individual country inflation and growth performance differ.

We also consider the issue of coupon payments on medium-term bonds. The presence of coupon payments introduces a measurement error between observed yields to maturity and true returns to investments. The size of this error depends on the slope of the relevant segment of the yield curve. Our findings indicate that the use of raw data on yields to maturity does not induce systematic measurement errors, at least large enough to matter for the results.

We use the above formulation to re-examine the RUIP between Canada and the USA using annual data for the period 1972–2006. These two neighbouring countries represent an interesting case study since the Canadian economy is closely intertwined with that of the USA through both commodity and capital flows, as well as through exchanges of technology and even labour, and through bilateral and multilateral trade agreements such as NAFTA (North American Free Trade Agreement). Therefore, one should expect that there is a systematic relationship between the real exchange rate (Can\$/US\$) and real (Canadian – US) interest rate differential. Nevertheless, this conjecture has often been rejected in the literature (see Edison & Melick, 1999; Edison & Pauls, 1993; Hoffmann & MacDonald, 2003).

The paper is organized as follows. In Section 2 we give a brief literature review. In Section 3 we discuss the theoretical considerations. The data set and empirical investigations are fully described in Section 4. Section 5 concludes and draws some policy implications.

¹ Some institutions (IMF, OECD, EC) may calculate minimal benchmarks (values) for the CAD in order to secure that the actual budget deficit, of a country, will not breach a specific safety level set for the medium term. *Ceteris paribus*, the higher the volatility of an economy and the higher the sensitivity of the budget to the cycle, the more stringent will be the minimal benchmarks for the CAD in the medium term. These safety levels are particularly important for countries with high stock of government debt or when there is a need to make room for the consequences of ageing, and so on. Of course, we should mention that in many occasions when a country exceeds the safety levels for the actual budget deficit this could be related not only to the cyclical component of the budget but also to unforeseen fiscal developments, such as unexpected tax shortfalls, unexpected spending overruns and the budgetary impact of interest rate shocks. The latter may be of a serious problem especially for highly indebted countries whose budget is more vulnerable than that of the low-debt countries.

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