Business Forecasting

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Title: Testing Purchasing Power Parity and Forecasting Real Exchange Rates: A Case Study of India and the USA

Table of Contents

1. Introduction

This report investigates the validity of Purchasing Power Parity (PPP) between India (home country) and the USA (foreign country) and forecasts the Real Exchange Rate (RER) using time series analysis. The study utilizes monthly data spanning January 2013 to December 2024 to test both absolute and relative PPP hypotheses, followed by Box-Jenkins ARIMA modelling to forecast the RER. The findings offer valuable insights into exchange rate behaviour and its relationship with inflation differentials.

1.1. Approach

India and the USA were selected as the home and foreign countries, respectively, due to the availability and reliability of macroeconomic data. Initially, the dataset consisted of annual observations from 2013 to 2024. However, it was later refined to monthly frequency to enhance the statistical power of the analysis and to better capture seasonality and volatility clusters in the exchange rate dynamics. The analysis was performed using Python, chosen for its robust time series libraries and the team's familiarity with the language. To evaluate model performance, the log-transformed RER data was divided into:

- **Training set**: January 2013 – December 2023
- **Test set**: January 2024 – December 2024

This structure ensures that the forecasting model is validated against unseen data, enabling a realistic assessment of its predictive capability.

1.2. Key Objectives:

1. To analyse the statistical properties of the variables in their logarithmic form.
2. To test the validity of absolute and relative Purchasing Power Parity (PPP) between India and the USA.
3. To estimate and compare various time series models.
4. To model and forecast the Real Exchange Rate (RER) using the most appropriate model based on diagnostic and predictive accuracy.

1.3. Key Terminologies and definitions-

1. NER (Nominal Exchange Rate): The rate at which one currency can be exchanged for another, without adjusting for price level differences (e.g., 83 INR/USD).
2. RER (Real Exchange Rate): The RER adjusted for relative price levels (typically using CPI) between two countries. It reflects the true purchasing power of one currency relative to another.
3. CPI (Consumer Price Index): A measure of average price changes in a fixed basket of goods and services over time. It serves as a proxy for inflation in both home and foreign countries.
4. Purchasing Power Parity (PPP): An economic theory suggesting that exchange rates should adjust to equalise the price of identical goods and services in different countries. This can be tested in its absolute and relative forms.
5. Autocorrelation Function (ACF): A statistical tool quantifying the correlation between a time series and its past values over various lags. It is useful for detecting patterns such as seasonality.
6. Partial Autocorrelation Function(PACF): Measures the direct correlation between a time series and its lagged values, controlling for the influence of intervening lags. It helps in model identification, especially in ARIMA modelling.

2. Data Collection and Preparation

2.1. Dataset description

Nominal Exchange Rate (NER) and Consumer Price Indices for home and foreign countries in the (CPI_Home and CPI_Foreign) dataset were collected from the World Bank Group's Global Economic Monitor for home and foreign currencies (INR/USD). Since the data for real exchange rate (RER) was not directly available, a calculated column for RER has been created using the formulae:

$$ReR = NER\left(\frac{CPI_{USA}}{CPI_{INDIA}}\right)$$

2.2 Data Transformations

The following log-transformed variables were created to facilitate econometric analysis:

- Log of Nominal Exchange Rate (log_NER): ln (NER_t).
- Log of Real Exchange Rate (log_RER): ln (RER_t).
- Log of CPI for Home (India) and Foreign (USA): ln $(CPI_{home,t})$ and ln $(CPI_{foreign,t})$.

The log transformation has helped with:

- Linearization: Converts multiplicative relationships (e.g., exponential trends in exchange rates) into additive ones, simplifying linear modelling.
- Variance Stabilization: Mitigates heteroskedasticity, a common issue in macroeconomic time series.
- Interpretability: Coefficients in log models represent elasticities (percentage changes), critical for inflation and exchange rate studies.

Initial calculations like RER derivation and log transforms were performed in Microsoft Excel for transparency and cross-verification. Data was then imported to Python for advanced analysis.

3. Descriptive Analysis

	CPI_Home	Nominal Exchange Rate	Real Exchange Rate	CPI_Foreign	log_NER	log_CPI_Home	log_CPI_Foreign	log_RER
Date								
2013-01-01	128.155340	54.251652	45.094921	106.524958	3.993633	4.853243	4.668379	3.808770
2013-02-01	129.975728	53.823100	44.351634	107.103380	3.985703	4.867348	4.673795	3.792150
2013-03-01	130.218447	54.406659	44.623107	106.802214	3.996487	4.869213	4.670979	3.798252
2013-04-01	130.703883	54.359826	44.326361	106.579214	3.995625	4.872934	4.668888	3.791580
2013-05-01	131.432039	54.997174	44.616086	106.623354	4.007282	4.878490	4.669303	3.798094

Figure 3.1: Dataset

The dataset, when viewed in Python, was presented as shown in figure 3.1. The dates were converted to a standardized format for readability. The descriptive statistics of the dataset are presented as shown in figure 3.2. The Log transformed variables show asymmetric inflation.

- log_CPI_Home (India): Mean = 5.16, Std Dev = 0.17

- log_CPI_Foreign (USA): Mean = 4.78, Std Dev = 0.10

	CPI_Home	Nominal Exchange Rate	Real Exchange Rate	CPI_Foreign	log_NER	log_CPI_Home	log_CPI_Foreign	log_RER
count	144.000000	144.000000	144.000000	144.000000	144.000000	144.000000	144.000000	144.000000
mean	177.562871	70.644353	48.060681	120.290088	4.251230	5.164980	4.784876	3.871125
std	30.367953	8.025665	2.519336	12.385874	0.113962	0.169595	0.099517	0.051694
min	128.155340	53.823100	43.691067	106.524958	3.985703	4.853243	4.668379	3.777144
25%	153.792476	64.445419	46.448575	109.444659	4.165819	5.035601	4.695419	3.838346
50%	169.963592	69.718163	47.471899	116.222274	4.244460	5.135584	4.755505	3.860138
75%	201.729369	75.693403	49.321888	129.312882	4.326691	5.306926	4.862231	3.898367
max	237.378641	84.994318	53.143622	146.032425	4.442584	5.469657	4.983829	3.972998

Figure 3.2: Descriptive statistics

This implies that India's inflation was persistently higher and more volatile than the U.S. On the other hand, a real exchange rate (Log_RER) reveals structural deviations. Mean of log_RER (3.87) < log_NER (4.25) which could indicate that The INR was weaker in real terms than nominal terms, confirming long-term PPP violations.

The figure 3.3 presents log-transformed time series plots. The log-transformed economic indicators reveal important trends in the India-USA exchange rate and inflation dynamics from 2013 to 2024. The nominal exchange rate (log (NER)) shows a steady upward trend, indicating a depreciation of the Indian rupee against the US dollar over time.

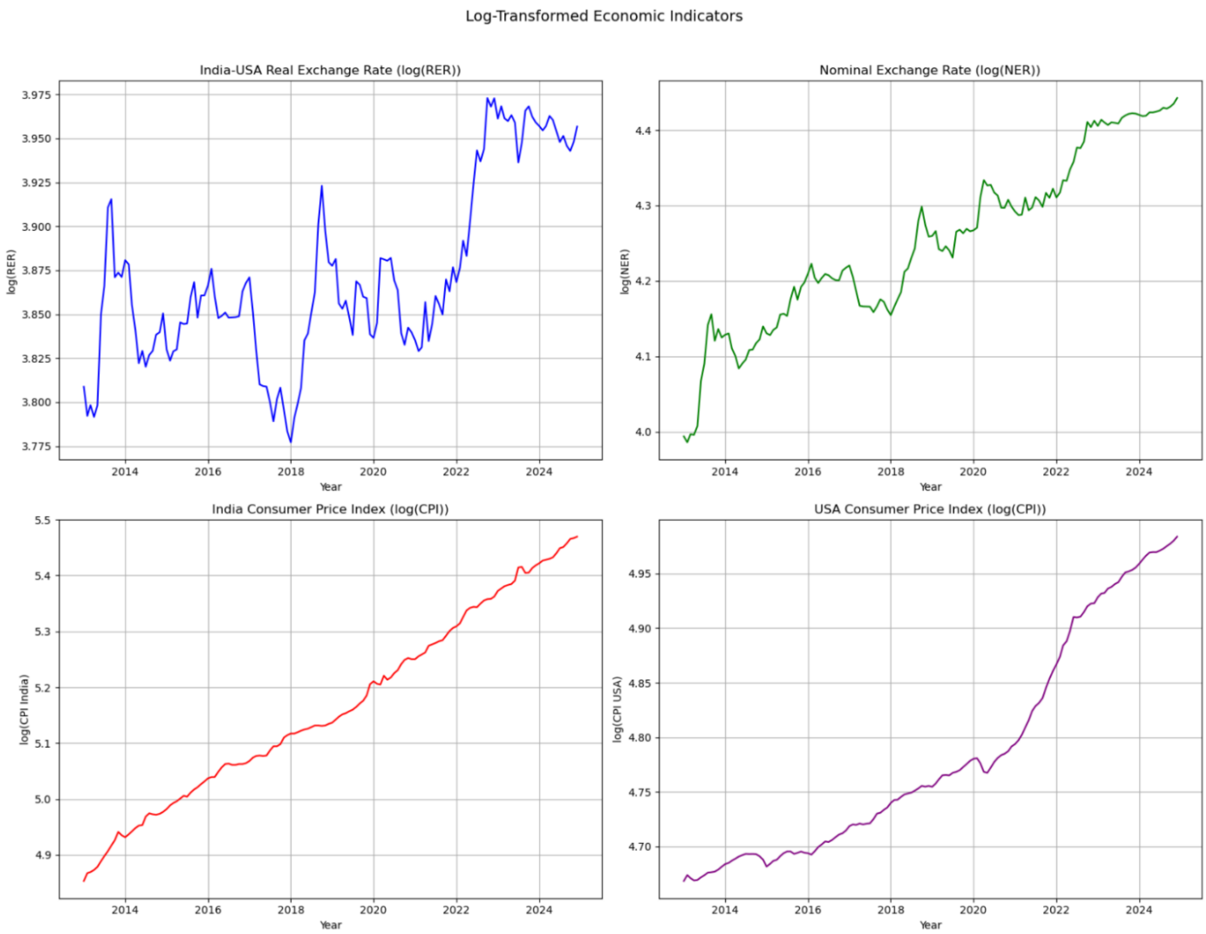

Figure 3.3: Log-transformed time series plots

In contrast, the real exchange rate (log (RER)) is more volatile, reflecting the influence of relative price levels between the two countries, with a notable dip around 2017–2018 and increased fluctuations post-2021. Both India and the USA exhibit upward trends in their Consumer Price Indices (log(CPI)), signifying persistent inflation, though the USA's CPI shows a sharper rise after 2020, likely due to pandemic-related economic effects. The log transformation helps stabilize variance, linearize growth patterns, and makes it easier to interpret percentage changes, making these visualizations valuable for analysing long-term macroeconomic relationships and preparing data for further forecasting or econometric analysis.

4. Results and Discussion

4.1. Stationarity Tests

Stationarity tests are critical for time-series analysis as most econometric models (e.g., ARIMA, OLS) assume data is stationary i.e., they have constant mean and variance over time. Non-stationary data can lead to spurious regression results. The Augmented Dickey-Fuller (ADF) test was employed to verify stationarity, with:

- Null Hypothesis (H_0): The series has a unit root (non-stationary).
- Alternative (H_1): The series is stationary.

4.1.1. Observations:

On checking testing the stationarity for Real Exchange Rate (log_RER), the following were the observations:

- Levels:
  i. Test Statistic: -1.8868 (p-value: 0.3383)
  ii. Conclusion: Non-stationary (failed to reject H_0 at 1%, 5%, 10% critical values).
- First Differences (Δlog_RER):
  i. Test Statistic: -10.3079 (p-value: 0.0000)
  ii. Conclusion: Stationary (rejects H_0 at all significance levels).

	Variable	Test Statistic	p-value	1% Critical	5% Critical	10% Critical	Conclusion
0	log_RER	-1.8868	0.3383	-3.4773	-2.8821	-2.5777	NON-STATIONARY
1	diff_log_RER	-10.3079	0.0000	-3.4773	-2.8821	-2.5777	STATIONARY
2	log_NER	-1.5399	0.5137	-3.4769	-2.8820	-2.5777	NON-STATIONARY
3	diff_log_NER	-10.1324	0.0000	-3.4773	-2.8821	-2.5777	STATIONARY
4	log_CPI_Home	-0.1896	0.9397	-3.4776	-2.8823	-2.5778	NON-STATIONARY
5	diff_log_CPI_Home	-10.5027	0.0000	-3.4776	-2.8823	-2.5778	STATIONARY
6	log_CPI_Foreign	0.5602	0.9866	-3.4794	-2.8830	-2.5782	NON-STATIONARY
7	diff_log_CPI_Foreign	-2.1562	0.2225	-3.4794	-2.8830	-2.5782	NON-STATIONARY
8	diff2_log_CPI_Foreign	-8.6531	0.0000	-3.4794	-2.8830	-2.5782	STATIONARY

Figure 4.1: ADF Stationarity Test Results

From the stationarity test, it can be inferred that it is an I (1) series (d = 1), supporting the use of ARIMA(p,1,q) for forecasting.

4.2. Cointegration Test

Cointegration analysis tests whether a set of non-stationary variables share a long-run equilibrium relationship. If variables such as log-transformed Real Exchange Rate (log (RER)) and other economic indicators are found to be cointegrated, this suggests that while they may individually follow non-stationary paths, they are bound by a stable long-term relationship.

In such cases, modelling should not be limited to a standard ARIMA framework, which captures only short-term dynamics. Instead, an Error Correction Model (ECM) becomes necessary. The ECM incorporates both short-term fluctuations and adjustments towards the long-run equilibrium, thus providing a more comprehensive representation of the data-generating process when cointegration exists.

To determine the presence of cointegration, the Engle-Granger two-step procedure was employed. If the residuals are stationary (i.e., I(0)), this indicates that the variables are cointegrated. In that case, an ECM must be adopted. Conversely, if cointegration is not present, each variable can be modelled individually using ARIMA processes without including an error correction term.

This approach ensures the choice of time series models is aligned with the underlying data characteristics and relationships among variables, thus enhancing the robustness of forecasts and inferences.

4.2.1. Observation:

Cointegration Test Results

Dependent (Y)	Independent (X)	Test Statistic	p-value	1% Critical	5% Critical	10% Critical	Conclusion
log_NER	log_RER	-1.9807	0.5386	-3.9747	-3.3792	-3.0742	Not Cointegrated
log_CPI_Home	log_RER	-2.0608	0.4969	-3.9747	-3.3792	-3.0742	Not Cointegrated
log_CPI_Foreign	log_RER	-2.5167	0.2717	-3.9747	-3.3792	-3.0742	Not Cointegrated

Figure 4.2: Cointegration Test results

All test statistics exceed the 10% critical value (−3.0742), with high p-values ($p>0.05$), indicating no evidence of cointegration. The strongest (but still insignificant) relationship is between log_CPI_Foreign and log_RER (test statistic: −2.5167). Since no cointegration exists, a univariate ARIMA model for log_RER (with d=1from ADF tests) is statistically valid. ECM will not be required as Error correction terms are unnecessary, simplifying the forecasting approach.

5. Testing Purchasing Power Parity

The Purchasing Power Parity was tested to determine whether exchange rates between the currencies of India (home) and the USA (foreign) align with the economic theory that links currency values to price levels.

5.1. Absolute PPP

5.1.1. Objective:

To test whether the Nominal Exchange rate (NER) equals the ratio of price levels (CPIs) between India and the USA.

$$NER = \frac{CPI_{India}}{CPI_{USA}}$$

Expressed in logarithms as:

$$log(NER_t) = \alpha + \beta(log(CPI_{USA,t}) - log(CPI_{India,t})) + u_t$$

The above equation was estimated using Ordinary Least Squares (OLS) regression with 144 monthly observations. Additionally, the residuals from the regression were tested for stationarity using the Augmented Dickey-Fuller (ADF) test to assess long-run equilibrium.

5.1.2. Observation:

- Estimated coefficient $\beta = -1.35$, which significantly differs from the theoretical value of 1 (p-value < 0.001).
- R-squared = 0.852, suggesting a strong fit statistically, but not economically meaningful due to sign reversal.

- ADF Test on residuals yields a p-value = 0.191, indicating that the residuals are non-stationary and thus no cointegration exists between NER and relative price levels.

Component	Estimated Value	Theoretical (PPP)	Implication
Intercept (α)	3.7370	0	Rupee overvaluation ($\alpha \neq 0$)
CPI Differential Coefficient (β)	-1.3528	1	Inverse relationship ($\beta \neq 1$)
R-squared	0.8520	-	High explanatory power but wrong relationship
ADF Test Statistic (Residuals)	-2.2416	Stationary ($p < 0.05$)	Non-stationary residuals ($p > 0.05$)
ADF p-value (Residuals)	0.1915	-	No long-run equilibrium

Figure 5.1: Absolute PPP test results

The regression shows a significant relationship in magnitude, but the opposite in sign, and with non-stationary residuals, Absolute PPP is rejected both statistically and economically.

5.1.3. Interpretation & Economic Implications:

The results provide strong evidence against Absolute PPP. Although a high R^2 might suggest a good model fit, the negative β contradicts the economic intuition behind PPP, where a higher CPI in the USA relative to India should depreciate the Indian Rupee (increase NER), not the opposite.

Moreover, the non-stationary residuals indicate that no long-run equilibrium relationship exists between NER and the relative price ratio. This finding invalidates the core assumption of Absolute PPP that price level differences are the sole driver of exchange rate movements.

This implies that real-world exchange rates are influenced by a broader set of macroeconomic and financial forces, such as capital flows (e.g., Foreign Direct Investment, portfolio investments), speculative trading, monetary policy differentials, and central bank strategies (Rogoff, 1996).

Hence, while relative prices may affect long-run exchange rate trends, Absolute PPP fails to capture the full complexity of currency valuation in a globalised and financially integrated world. Given the empirical rejection of Absolute PPP, relying solely on inflation differentials for exchange rate forecasting or policy analysis may lead to misleading conclusions. Policymakers and analysts should incorporate broader financial indicators and macroeconomic fundamentals into their exchange rate models.

5.2. Relative PPP

5.2.1. Objective:

To test the Relative PPP hypothesis, which states that changes in exchange rates should reflect inflation differentials between countries. Under this theory, the rate of depreciation of a currency equals the difference in inflation rates between the domestic and foreign countries:

$$\Delta log(NER_t) \ = \ \gamma + \delta(\Delta log(CPI_{USA,t}) - \Delta log(CPI_{India,t})) + u_t$$

If Relative PPP holds, the coefficient should be equal to 1, indicating a one-to-one pass-through of inflation differences into exchange rate changes. The regression was estimated using monthly data over 144 observations, where:

- $\Delta log(NER_t)$ is the monthly change in the logarithm of the nominal exchange rate (INR/USD).
- $\Delta log(CPI_{USA,t}) - \Delta log(CPI_{India,t})$ is the inflation differential between the U.S. and India.

5.2.2. Observation:

- Estimated coefficient (δ) = −0.1485
- p-value = 0.495, indicating the coefficient is not statistically different from zero.
- R-squared = 0.003, suggesting that inflation differentials explain virtually none of the variation in exchange rate changes.

Component	Estimated Value	Theoretical (PPP)	Implication
Intercept (γ)	0.0028	-	Small but significant drift (p=0.022)
Inflation Differential Coefficient (δ)	-0.1485	1	No relationship (p=0.495), opposite of PPP prediction
R-squared	0.003000	-	Virtually no explanatory power
F-statistic (p-value)	0.4679 (p=0.495)	Significant (p<0.05)	Overall model insignificant

Figure 5.2: Relative PPP test results

Relative PPP is statistically and economically rejected. The very low explanatory power (R^2 = 0.003) and insignificant coefficient indicate that changes in INR/USD are not explained by short-run differences in inflation rates between India and the U.S. Furthermore, the sign of is negative, suggesting the opposite direction of what Relative PPP predicts.

5.2.3. Interpretation & Economic Implications:

These findings imply that short-term exchange rate dynamics are largely disconnected from inflation fundamentals. In other words, price-level movements between countries do not translate into proportional exchange rate adjustments every month. This deviation from Relative PPP in the short run is well-documented in the literature (Taylor & Taylor, 2004), often attributed to market frictions and a broader range of economic forces beyond inflation. Several factors likely contribute to this breakdown of Relative PPP in the short run:

- Speculative capital flows, portfolio shifts, and foreign direct investment (FDI).
- Interest rate differentials and expectations of monetary policy.
- Market sentiment, news shocks, and geopolitical events.
- Central bank interventions, particularly by the Reserve Bank of India (RBI) in the foreign exchange market.
- Exchange rate regimes: The INR/USD is under a managed float, meaning the RBI influences exchange rates, dampening the automatic adjustment suggested by Relative PPP.

Moreover, transaction costs, capital controls, and differential speeds of price adjustment across borders may hinder the realisation of short-run PPP conditions. In exchange rate modelling and forecasting, this result emphasises the need to integrate financial and behavioural factors, rather than relying on simple inflation-based models.

6. ARIMA Model Selection and Forecasting

6.1. Methodology

The objective of this section is to identify and estimate the most appropriate ARIMA(p,d,q) models for forecasting the Real Exchange Rate (RER) series. The process followed a structured time series modelling approach using both statistical tests and graphical diagnostics.

6.1.1. Stationarity and Differencing

As outlined in Section 4, the Augmented Dickey-Fuller (ADF) test confirmed that the original series is non-stationary in levels but becomes stationary after first differencing, indicating the series is integrated of order one, I(1). Consequently, the differencing order was set as d=1 for all model specifications.

6.1.2. ACF and PACF Diagnostics for Model Identification

To determine the autoregressive (AR) and moving average (MA) components, the Autocorrelation Function (ACF) and Partial Autocorrelation Function (PACF) were plotted for the differenced log RER series.

- ACF Characteristics:
  - Significant spikes across multiple lags (lag 1 through ~10).
  - Gradual tapering pattern (slow decay) without a clear cutoff.
  - Suggests the presence of Moving Average (MA) components, but the appropriate lag order is not immediately obvious.

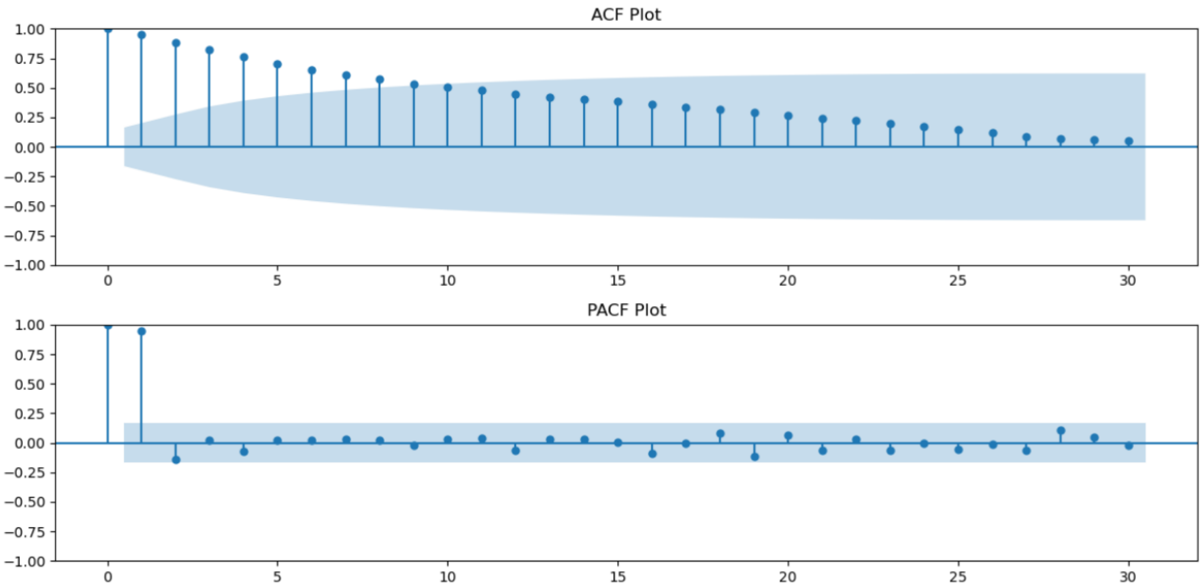

Figure 6.1: ACF and PACF plot

- PACF Characteristics:
  - A sharp cutoff after lag 2, with the first two lags significantly outside the confidence bounds.
  - Indicates a clear Autoregressive (AR) structure, particularly an AR (2) process.

Based on the diagnostic observations, six candidate models were selected to balance simplicity, explanatory power, and representation of both AR and MA dynamics. Each model maintains d=1, while the AR and MA orders are varied systematically to explore alternative specifications.

6.2. ARIMA Model Candidates and Justification

Model	**ARIMA(p,d,q)**	**Justification and significance**
Model 1	(2,1,0)	Based on PACF cutting off at lag 2. No MA terms were included to test the sufficiency of AR (2) alone. Helps examine if AR terms can fully capture the autocorrelation.
Model 2	(2,1,1)	Builds on Model 1 by adding MA (1), responding to the slow decay in ACF. Tests if minimal MA structure enhances fit.
Model 3	(2,1,2)	Further expands MA component to better handle autocorrelation in residuals.
Model 4	(1,1,1)	Includes minimal AR and MA terms, reflecting initial ACF/PACF significance at lag 1. Acts as a benchmark model due to its balanced and widely used structure.
Model 5	(0,1,2)	Focuses exclusively on the MA side, isolating its contribution. Tests if the entire dynamics can be captured without AR terms.
Model 6	(1,1,2)	Compromise model with lower AR order but extended MA component. Captures complexity of MA (2) while retaining AR (1) for observed lag dependence.

Table 6.1: ARIMA model selection

The models selected as shown in Table 6.1 have been estimated and evaluated using a three-stage model selection process, including T-tests, Q-statistics, and finally AIC/BIC for final ranking.

6.3. Model Selection Process

To determine the best-fit ARIMA model, a three-stage selection methodology was employed:

- T-test
- Q-test
- AIC/BIC ranking

This process ensured that model parameters were statistically significant, residuals were white noise, and the model fit was optimal.

6.3.1. T-Test – Statistical Significance of Coefficients

Each ARIMA model's coefficients were evaluated using the t-test, where the null hypothesis is that a coefficient equals zero. The selection rule was:

- The coefficient is significant if p-value < 0.05.
- A model is accepted if no more than one coefficient (excluding error variance) is insignificant.

No models passed the strict t-test. However, ARIMA (2,1,1) and ARIMA (1,1,2) had only one insignificant coefficient. These were considered for further testing based on Q-test and AIC. While ideally, all model coefficients should be statistically significant, relaxing this threshold to allow one insignificant term is a defensible and widely used compromise in empirical modelling, especially when the model performs well on other diagnostic criteria. Such flexibility is common in time series forecasting studies where perfect statistical purity is weighed against real-world forecasting performance (Enders, 2014; Franses, 1998).

Model	Order	AR.L1.pval	AR.L2.pval	MA.L1.pval	MA.L2.pval	Insignificant Terms	Passes T-test	AIC	BIC
ARIMA(2,1,0)	(2, 1, 0)	0.154	0.467	1.000	1.000	2	False	-730.200000	-721.600000
ARIMA(2,1,1)	(2, 1, 1)	0.014	0.598	0.000	1.000	1	True	-729.800000	-718.300000
ARIMA(2,1,2)	(2, 1, 2)	0.980	0.829	0.935	0.848	4	False	-727.600000	-713.200000
ARIMA(1,1,1)	(1, 1, 1)	0.592	1.000	0.297	1.000	2	False	-730.500000	-721.900000
ARIMA(0,1,2)	(0, 1, 2)	1.000	1.000	0.216	0.567	2	False	-730.300000	-721.700000
ARIMA(1,1,2)	(1, 1, 2)	0.019	1.000	0.006	0.664	1	True	-729.800000	-718.300000

Figure 6.2: t-test result

Shortlisted Models from this step are:

- ARIMA (2,1,1)
- ARIMA (1,1,2)

6.3.2. Q-Test – Residual Diagnostic for Autocorrelation

The residuals of the shortlisted models were tested using the Ljung-Box Q-test to verify if they resemble white noise (i.e., no remaining autocorrelation).

- Null Hypothesis H_0: No autocorrelation in residuals.
- Significance level: 0.05
- Criteria: A model passes if p-value > 0.05, meaning residuals are uncorrelated.

Both models ARIMA (2,1,1) and ARIMA (1,1,2) successfully passed the Q-test, indicating that their residuals do not exhibit autocorrelation.

6.3.3. AIC/BIC

Finally, models that passed both earlier stages were ranked using Akaike Information Criterion (AIC) and Bayesian Information Criterion (BIC):

- Lower values indicate better model fit with appropriate complexity.
- AIC favours goodness-of-fit, and BIC penalizes model complexity more heavily.

While both models were competitive, ARIMA (2,1,1) was chosen as the best fit due to its slightly better AIC/BIC scores, statistical validity (t-test), and uncorrelated residuals (Q-test). This model serves as the foundation for subsequent forecasting of the Real Exchange Rate and supports the economic analysis with a reliable empirical framework.

Model	Order	AR.L1.pval	AR.L2.pval	MA.L1.pval	MA.L2.pval	Insignificant Terms	Passes T-test	AIC	BIC	Q(4)_stat	Q(8)_stat	Q(12)_stat	Q(4)_pval	Q(8)_pval	Q(12)_pval	Passes All Q-tests	Qualified Model	Best Model
ARIMA(2,1,0)	(2, 1, 0)	0.154	0.467	1.000	1.000	2	False	-730.2	-721.6	0.00	0.05	0.07	1.0000	1.0000	1.0000	True	False	False
ARIMA(2,1,1)	(2, 1, 1)	0.014	0.598	0.000	1.000	1	True	-729.8	-718.3	0.01	0.05	0.07	1.0000	1.0000	1.0000	True	True	True
ARIMA(2,1,2)	(2, 1, 2)	0.980	0.829	0.935	0.848	4	False	-727.6	-713.2	0.01	0.05	0.07	1.0000	1.0000	1.0000	True	False	False
ARIMA(1,1,1)	(1, 1, 1)	0.592	1.000	0.297	1.000	2	False	-730.5	-721.9	0.00	0.05	0.07	1.0000	1.0000	1.0000	True	False	False
ARIMA(0,1,2)	(0, 1, 2)	1.000	1.000	0.216	0.567	2	False	-730.3	-721.7	0.00	0.05	0.07	1.0000	1.0000	1.0000	True	False	False
ARIMA(1,1,2)	(1, 1, 2)	0.019	1.000	0.006	0.664	1	True	-729.8	-718.3	0.01	0.05	0.07	1.0000	1.0000	1.0000	True	True	False

Figure 6.3: Model Selection

7. Forecast Results

Following the three-stage model selection process (t-test → Q-test → AIC/BIC), the ARIMA (2,1,1) model was identified as the best-fit specification for modelling the log-transformed Real Exchange Rate (log_RER). To assess its forecasting capability, the dataset was divided into a training set (Jan 2013 – Dec 2023) and a test set (Jan 2024 – Dec 2024). The model was trained on historical data and used to generate 12-step-ahead forecasts for the year 2024.

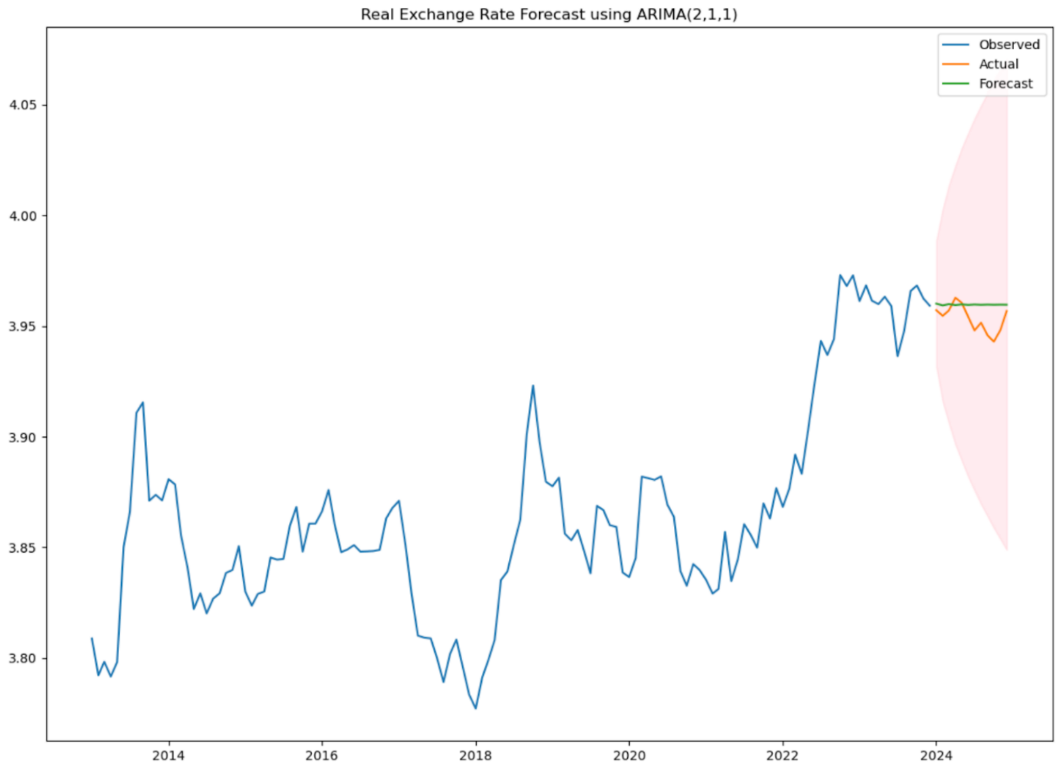

Figure 7.1: 12-step-ahead forecast

The forecast plot generated using the ARIMA (2,1,1) model visually compares the observed, actual, and forecasted values of the real exchange rate for the test period (2024). The model's 12-step-ahead forecast closely follows the actual values, staying within the 95% confidence interval (figure 7.1). This visual alignment reaffirms the low forecast error metrics and highlights the model's reliability in capturing short-term dynamics in the real exchange rate. The gradual widening of the confidence band reflects increasing uncertainty over time, which is a typical characteristic of time series forecasts.

7.1. Training Validation

- The residuals from the ARIMA (2,1,1) model showed no significant autocorrelation, confirmed by the Ljung-Box Q-test (p-value = 0.99).
- This indicates that the model has captured all systematic patterns in the training data and the residuals behave like white noise.

7.2. Forecast Evaluation on Test Data

The performance of the model on the out-of-sample test period (2024) was evaluated using standard accuracy metrics:

Metric	**Value**
Mean Squared Error (MSE)	0.000075
Mean Absolute Error (MAE)	0.007063
Root Mean Squared Error (RMSE)	0.008640

Table 7.1: Model Performance

These results suggest that the model performed remarkably well in forecasting the real exchange rate. The visual representation shown in Figure 7.1 further supports this, showing a close alignment between the actual and predicted values over the 2024 test period.

7. 3. Economic Interpretation

- The RMSE of 0.0086 indicates that, on average, the model's forecast deviates from the actual log (RER) by less than 1%, which is economically negligible.
- Given the volatile and complex nature of exchange rates influenced by multiple macroeconomic and financial forces, achieving this level of predictive accuracy is noteworthy.

- This shows that even simple forecasting models like ARIMA (2,1,1) can work well for short-term predictions, making them useful for real-world business and policy decisions.

8. Conclusion

This report investigated the validity of Purchasing Power Parity (PPP) between India and the USA and developed an ARIMA model to forecast the real exchange rate (RER). The analysis rejected both absolute and relative PPP, demonstrating that exchange rate movements are driven more by financial factors (e.g., capital flows, interest rates) than inflation differentials. These results underscore that relative price levels do not solely influence exchange rates. Instead, financial market dynamics such as interest rate differentials, capital flows, and speculative behaviour play a more dominant role in driving INR/USD exchange rate volatility. Initial model development using annual data proved insufficient due to limited observations and weaker statistical power. Switching to monthly data (2013–2024) significantly improved model estimation and validity, highlighting the critical role of sample size and frequency in time series analysis.

The best ARIMA model was selected after a rigorous evaluation process involving:

- ACF/PACF analysis identified initial parameters, with PACF indicating an AR(2) structure and ACF suggesting MA components.
- T-tests and Q-tests ensured statistical validity, confirming significant coefficients and white-noise residuals.
- AIC/BIC criteria refined the selection, favouring ARIMA (2,1,1) for its balance of accuracy and simplicity.

Using ARIMA (2,1,1), 12-month forecasts (for 2024) were generated and validated using the test dataset (Jan–Dec 2024). The model achieved strong forecasting performance (MAE < 1%), validating its utility for short-term exchange rate predictions. The forecast errors were less than 1% of log (RER) values, demonstrating high accuracy. This suggests that the ARIMA (2,1,1) model is practically useful for short-term exchange rate forecasting, especially when inflation-based models like PPP fail to explain currency dynamics.

This study validates the superiority of time series approaches like ARIMA over simplistic PPP-based frameworks for real-world exchange rate forecasting. While theoretical models assume long-run price alignment, empirical evidence shows that financial volatility, not inflation, drives exchange rate behaviour. Data frequency, model diagnostics, and layered selection criteria were all crucial to achieving a statistically sound and economically meaningful forecasting model.

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Appendix

The complete Python implementation for this project—including data processing, statistical tests, and ARIMA forecasting—is available here: Python_code_file