

- Thesis Title: **“The Effect of Oil Prices and Regime Switches on Real Effective Exchange Rate in Pakistan: A Markov Regime Switching Approach”**

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ABSTRACT

Oil is becoming one of the important component of economic system of Pakistan with increase in its demand. Also oil prices being exogenous are contributing to impact the exchange rate including different exchange rate regime dummies in data. In this study following (Meese and Rogoff, 1988) and (Throop, 1993) Interest Rate Parity has been used to construct a model by using real effective exchange rate, Dubai crude oil price and interest rate differential. Bealieu and Miron (1992) seasonal unit root test, Engle and Granger (1987), Gregory and Hansen (1996) and Johansen (1988) methods of cointegration are applied followed by Markov switching vector error correction model based on Hamilton (1989) are used to test for the long and short run dynamics and impact of change of exchange rate regime on real effective exchange rate using monthly data from 1970m01 to 2014m03 in context of Pakistan with the use fixed exchange rate regime, managed floating exchange rate regime, two-tier exchange rate regime, unified exchange rate regime and floating exchange rate regime. Through examining the results all variables are found to be integrated of order one with the significant intercept and seasonal dummies and insignificant trend (C,d,nt) and insignificant intercept, seasonal dummies and trend (nC,nd,nt). The long run relationship has been examined between real effective exchange rate and Dubai crude oil price in case of all exchange rate regimes with the use of regime dummies and interaction terms except for no regime, two-tier exchange rate regime and unified exchange rate regime. Similarly between real effective exchange rate and interest rate differential long run relationship has been examined in all the exchange rate regimes. Long run and dynamic result has also been detected except for interest rate differential with the use of exogenous exchange rate regime dummies. Oil price impacting exchange rate positively in both long and short run, while interest rate differential negatively effects exchange rate in long run. Through examining the results for impact of exchange rate regime switching on exchange rate, during 1970-2000 structural shifts were causing the change in exchange rate regimes with depreciation being high during this period.