The Purchasing-Power Parity Doctrine: A Reappraisal

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I

THE purchasing-power parity doctrine has had its ebbs and flows over the years. Interest in the doctrine arose whenever existing exchange rates were considered unrealistic and the search began for the elusive concept of equilibrium rates. It was first invoked—although in somewhat ambiguous terms—in the period of the Napoleonic wars,[1] it received its christening at the hands of Gustav Cassel during World War I,[2] and it was resurrected after World War II.[3] It has also had its critics, among others Taussig after World War I[4] and Haberler after World War II,[5] but it has managed to survive nevertheless.

In recent years, new efforts have been made to clothe the purchasing-power parity doctrine in the garments of respectability, and a proposal has also been put forward to use this doctrine as a guide in establishing equilibrium exchange rates.[6] At the same time, new statistical material has become available that has a bearing on the relationship between purchasing-power parities and exchange rates. It may be of interest, therefore, to reexamine the claims put in for the validity of the purchasing-power parity doctrine.

The purchasing-power parity doctrine means different things to different people. In the following, I shall deal with two versions of this theory that can be appropriately called the "absolute" and the "relative" interpretation of the doctrine. According to the first version, purchasing-power parities calculated as a ratio of consumer goods prices for any pair of countries would tend to approximate the equilibrium rates of exchange. In turn, the relative interpretation of the doctrine asserts that, in comparison to a period when equilibrium rates prevailed, changes in relative prices would indicate the necessary adjustments in exchange rates.

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Although his name has come to be associated with the relative interpretation of the purchasing-power parity doctrine, Cassel also formulated the absolute hypothesis by arguing that "the rate of exchange between two countries will be determined by the quotient between the general levels of prices in the two coun-

[1] For references, see Gottfried Haberler, *A Survey of International Trade Theory* (rev. ed.; "Special Papers in International Economics," No. 1 [Princeton, N.J.: International Finance Section, Princeton University, 1961]), pp. 46–47.

[2] Gustav Cassel, "Abnormal Deviations in International Exchanges," *Economic Journal*, September, 1918, and further writings cited below.

[3] Cf., for example, A. H. Hansen, "A Note on Fundamental Disequilibrium," *Review of Economics and Statistics*, November, 1944 (reprinted in *Foreign Economic Policy for the United States*, ed. S. E. Harris [Cambridge, Mass., 1948]).

[4] F. W. Taussig, *International Trade* (New York, 1927), chap. xxvi.

[5] Gottfried Haberler, "The Choice of Exchange Rates after the War," *American Economic Review*, June, 1945.

[6] L. B. Yeager, "A Rehabilitation of Purchasing-Power Parity," *Journal of Political Economy*, December, 1958, pp. 516–30; and H. S. Houthakker, "Exchange Rate Adjustment," *Factors Affecting the United States Balance of Payments* (Washington: U.S. Congress Joint Economic Committee), pp. 287–304.