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New evidence on purchasing power parity from 17 OECD countries

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Abstract

There is a large literature that investigates whether or not real exchange rates are stationary in an attempt to unravel support for purchasing power parity (PPP). At best, the empirical results are mixed. This paper applies a unit root test that allows for a simultaneous structural break in the intercept and slope, shown by Sen ([2003](#)) to minimize power distortions, to examine PPP for 17 OECD countries. Our results on PPP are mixed. When the real exchange rate is based on the US dollar, evidence is found of

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I would like to thank Professor Mark Taylor for helpful comments and suggestions on an earlier version of this paper. I should also like to thank Professor Amit Sen for making available his GAUSS codes used to generate the results reported in this paper. Any errors or omissions are, however, my own.

Notes

Arguing in favour of using a time trend in testing for a unit root in real exchange rates, Shively ([2001](#), p. 202) states that ‘rejection of the random walk hypothesis in favour of the trend stationary alternative is evidence that the real exchange rate returns to a long-run equilibrium and therefore evidence in favour of a true long-run purchasing power parity relationship’. For further importance of incorporating a time trend in the model, see Marcela et al. ([2003](#)).

This section draws heavily on the work of Sen ([2003](#)).

He tests for the presence of a unit root in postwar US quarterly real GNP and all Nelson and Plosser ([1982](#)) series, except the unemployment series, based on Model C, unlike previous studies. His results are comparable to that of Zivot and Andrews ([1992](#)). Sen ([2003](#)) is able to reject the unit root null hypothesis for money stock, real wages and quarterly real GNP in addition to all series for which Zivot and Andrews ([1992](#)) rejected the unit root null. His results on real per GNP was much strong than Zivot and Andrews ([1992](#)). Moreover, Sen ([2003](#)) finds different break dates than Zivot and Andrews ([1992](#)) for some of the series.

In a recent contribution, Coakley et al. ([2004](#)) generalize the concept of long-run relative PPP to the case where the long-run elasticity of the nominal exchange rate with respect to the relative price of domestic and foreign goods is not necessarily equal to one. This sequence to be stationary. The test is based on the ADF test with a time trend. The test is based on the ADF test with a time trend. The test is based on the ADF test with a time trend.



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