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Mean reversion and structural breaks in real exchange rates: South African evidence

Oludele Akinloye Akinboade & Daniel Makina

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Abstract

The paper tests for mean reversion, that is, purchasing power parity (PPP), in the bilateral real exchange rate series of the South African rand against those of the dollar, the pound sterling, the euro and the yen, these being the currencies of the country's main trading partners. The relevance of considering structural breaks in PPP tests is demonstrated. Using standard unit root tests without considering structural breaks, one is unable to reject the null hypothesis of a unit root in the exchange rate series. The additive outlier model clearly demonstrates the importance of multiple sudden structural breaks and supports the stationarity of the rand's bilateral real exchange rates. As expected the innovative outlier model, which seeks to suggest gradual shifts, only identifies a limited number of breaks and does not support mean reversion.



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