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# Testing purchasing power parity hypothesis for transition economies

Ebru Guven Solakoglu

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## Abstract

This study tests the PPP hypothesis for transition economies by using a panel approach.

The results show that PPP holds for transition economies suggesting a half-life

convergence rate of 1.5 years for transition economies.

The results also suggest that transition economies are more open to international trade

and

economic

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Notes

<sup>1</sup> EBRD,

<sup>2</sup> Also see

<sup>3</sup> Note that the results we get from this exercise would neither be meaningful nor powerful since the period in question is 12 unbalanced years.

<sup>4</sup> Levin and Lin ([1993](#)) indicated from simulation exercises that the problem of limited power in unit root tests is severe for small samples: ‘For example, if 50 observations are generated by a stationary univariate model with first-order autocorrelation of 0.9, the augmented Dickey-Fuller (Dickey and Fuller, [1981](#)) test procedure (allowing for intercept and time trend, and using a 5 percent confidence level) rejects the unit root hypothesis in only 8 percent of the replications.’

<sup>5</sup> If a deterministic element like an intercept and/or a time trend is present in the data but not included in the model, the unit root test will be inconsistent (Levin and Lin, [1992](#)).

<sup>6</sup> As most of the univariate tests for transition countries suggested, an augmented Dickey-Fuller (ADF) test is conducted for one lag ( $k = 1$ ).

<sup>7</sup> The Im, Pesaran and Shin test procedure estimates each equation separately by OLS as in univariate tests, and test statistics are obtained by taking the averages of ADF t-statistics for each equation. In addition, Im, Pesaran and Shin perform the LM test, which is based on the standardized cross section average of the individual LM statistics in their 1997 study. Their simulations indicate better performance of the t-test and LM test over the Levin and Lin test in small samples, where the t-test performs better than the LM test. Therefore, we only report t-statistics for the IPS test procedure.

<sup>8</sup> Nickell ([1991](#)) suggests the following formula for adjustment,  $\hat{\rho}_T = (A_T - \rho)(T - 1)^{-1}$ , where  $A_T = -(1 + \rho) + (1 - \rho)(T - 1)^{-1}$ .

<sup>9</sup> Karlsson et al. (2007) use  $T = 10$ , two LL tests model, and the results are similar to those of Levin and Lin. In our case, the results, we use  $T = 12$ ,  $N = 21$ . So, we use the Levin and Lin test, and the results are similar to those of the Fisher test. Also, we use the Im, Pesaran and Shin test. Also see the results with t and LM tests for

<sup>10</sup> Note that some studies argue that rejection of unit root by a single country is enough to reject the unit root for the whole panel. Although time series for this study is too short to further discuss the unit root statistics for each country, we conducted a panel test on countries for which we do not reject a unit root, and obtained similar results to those above.

<sup>11</sup> Wu ([1996](#)) found the speed at which real exchange rates restore to equilibrium taking approximately two and a half years for one-time deviation from parity to be reduced by a half while supporting the long-run PPP for eighteen countries during the post-Bretton Woods period. Frankel and Rose ([1996](#)) found this speed to take approximately four years for a panel of 150 countries for a longer and unbalanced period (from 1948 to 1992).

<sup>12</sup> Score definitions are detailed under EBRD, annual transition reports, [Section II](#).

<sup>13</sup> Note that report adds another level of score described with a plus and minus signs to all categories. Plus and minus signs are treated by adding 0.3 and subtracting 0.3 from the full value. Therefore the highest score for an element would be 4.3, totalling to 12.9 for three elements.

<sup>14</sup> Notice that Bulgaria with a score of 10.9 is at the margin. Also note that it is an acceding country set to join the EU in 2007. With curiosity we repeated our test placing Bulgaria in the 'more open' sample, and the results did not change significantly.

<sup>15</sup> The data for openness factor starts in 1995. Therefore, we truncated and estimated the data accordingly. For comparison, we also estimated the original model using the truncated data.

<sup>16</sup> Note that the results for the first and second sections supported the results for the third section in this section.



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