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Real exchange rates and Purchasing Power Parity: mean-reversion in economic thought

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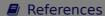
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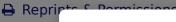


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⁴ In empirical tests the preponderance of studies assume that the purchasing power of a unit of currency is adequately measured by a national price index such as the consumer price index (CPI) or wholesale price index (WPI); other researchers have suggested the use of a traded-goods price index (TPI) (e.g. Xu, 2003).

- ⁵ That is after appropriate scaling to account for different base periods in the construction of the indices.
- ⁶ In particular, Wold's theorem, with the additional assumption that the moving average representation of the process is fully invertible.
- ⁷ Having is not a feasible alternative because this would imply explosive behaviour of the real exchange rate.
- ⁸ Fraser et al. (<u>1991</u>) test for unit roots in sectoral real exchange rates using disaggregated data.
- ⁹ Or, at least, of a lower order of integration than the individual processes.
- ¹⁰ Flood and Taylor (<u>1996</u>) find strong support for mean reversion towards long-run PPP using data on 21 industrialized countries over the floating rate period and regressing five-, ten- and twenty-year average exchange rate movements on average inflation



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