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## Applied Financial Economics >

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Original Articles

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

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### **Abstract**

This study provides a critical review of the research literature on long-run Purchasing Power Parity and the stability of real exchange rates.

## Notes

<sup>1</sup> For previous surveys of the PPP literature (see, Breuer, <u>1994</u>; Froot and Rogoff, <u>1995</u>; Taylor, <u>1995</u>; Rogoff, <u>1996</u>; Sarno and Taylor, <u>2002a</u>, <u>b</u>; Taylor and Taylor, <u>2004</u>).

<sup>2</sup> See Viner (1937) and Schumpeter (1954) for discussions of PPP and the classical economists.

<sup>3</sup> See Moggridge (<u>1972</u>) for a discussion of these views.

- <sup>4</sup> 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).
- <sup>5</sup> That is after appropriate scaling to account for different base periods in the construction of the indices.
- <sup>6</sup> In particular, Wold's theorem, with the additional assumption that the moving average representation of the process is fully invertible.
- <sup>7</sup> Having is not a feasible alternative because this would imply explosive behaviour of the real exchange rate.
- $^{8}$  Fraser et al. ( $\underline{1991}$ ) test for unit roots in sectoral real exchange rates using disaggregated data.
- <sup>9</sup> Or, at least, of a lower order of integration than the individual processes.
- <sup>10</sup> 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 differentials against the USA.
- $^{11}$  Taylor and Peel (2000) apply the ESTAR model to nominal exchange rates.
- <sup>12</sup> Indeed, Imbs et al. (2005) state: 'Non-linear dynamics of aggregate real exchange rates may be fully compatible with or at least observationally equivalent to [the] argument about the importance of heterogeneity at the disaggregated level.'

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