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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

¹ For previous surveys of the PPP literature (see, Breuer, [1994](#); Froot and Rogoff, [1995](#); Taylor, [1995](#); Rogoff, [1996](#); Sarno and Taylor, [2002a, b](#); Taylor and Taylor, [2004](#)).

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

³ See Moggridge ([1972](#)) for a discussion of these views.

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 $\rho < 1$ is not a feasible alternative because this would imply explosive behaviour of the real exchange rate.

⁸ Fraser et al. ([1991](#)) 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 ([1996](#)) 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.

¹² 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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