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Applied Financial Economics >

Volume 16, 2006 - Issue 1-2: Purchasing Power Parity and Real Exchange Rates

2,741 154

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

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Pages 1-17 | Published online: 19 Aug 2006

**66** Cite this article ▲ https://doi.org/10.1080/09603100500390067

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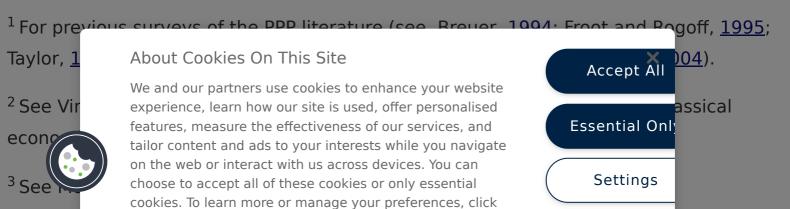
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#### **Abstract**

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

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<sup>4</sup> In emp

a unit of

- 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.
- <sup>8</sup> 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.
- <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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