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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, 1 ... 004).

[2] See Vir ... assical econo ...

[3] See ...

[4] In emp ... g power of a unit of ... 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. (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.’