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

Mark P. Taylor

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

<sup>8</sup> Fraser et al. ([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 ([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.

<sup>11</sup> Taylor

<sup>12</sup> Indeed, the fact that real exchange rates may be cointegrated does not imply that they are stationary. The argument is that the long-run equilibrium is not necessarily stable.



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