

## **Purchasing power parity under the European Monetary System**

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Using reduced rank cointegration analysis, this study examines whether exchange rate realignments are effective in extenuating the deviations from purchasing power parity (PPP) under the European Monetary System (EMS). In contrast to previous studies, more positive evidence for the PPP hypothesis is found. The difference in findings can be attributed partly to the statistical technique used, the correction of the finite sample bias, and the adjustment for realignment effects. In general, the results of this study support that currency realignments of the EMS have been effective in maintaining PPP among its member countries. (JEL F31, E58).

A major purpose of the European Monetary System (EMS) is to foster monetary stability and trade among its members. At the heart of the system is the quasi-fixed Exchange Rate Mechanism (ERM), under which intra-EMS rates are allowed to fluctuate within narrow bands around some mutually agreed upon central rates among the member countries. Significant changes in relative price levels can prompt exchange rate realignments, which are designed to maintain the competitiveness of the EMS members. Since the inception of the EMS in March 1979, the ERM has survived but through a number of realignments. An issue of interest is whether the member countries have been making efforts to coordinate monetary policies so as to maintain purchasing power parity (PPP) among them.

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Several arguments for a target zone arrangement like the EMS have been suggested. They include that the EMS is an effective disciplinary device for inflation-prone countries (Giavazzi and Pagano, 1988) and that the EMS can institute a short-run stabilizing effect on intra-EMS real and nominal exchange rates (Artis and Taylor, 1988; Diebold and Pauly, 1988; Ungerer *et al.*, 1986). The issue of welfare gains from the decrease in short-run volatility is still under debate (Artis and Taylor, 1988; Melitz, 1985). MacDonald and Taylor (1991) observe, however, that it may be more interesting to examine long-run exchange rate stabilization. Based on multivariate cointegration analysis, MacDonald and Taylor (1991) present evidence of long-run convergence in both nominal and real exchange rates for major EMS countries but not for non-EMS countries.

In the earlier EMS years, the ERM offered little anti-inflationary discipline, with Italy and France undergoing regular devaluations to offset higher inflation than in West Germany. By December 1991, values of the EMS currencies had been realigned 13 times despite heavy central interventions (see Table 1). Without currency realignments, those EMS countries with high inflation would lose competitiveness to the other low inflation countries. Furthermore, if each realignment did not fully offset the loss of competitiveness on the part of high inflation countries, deviations from PPP would not disappear. As a result, an issue to be examined is whether these realignments can be justified to maintain competitiveness (*ie* to maintain PPP) or whether these exchange rate adjustments only partially offset relative price changes due to purely political considerations.

Empirical studies on PPP for the EMS countries document conflicting results. Edison and Fisher (1991) report that relative prices and exchange rates are not cointegrated during the 1979–88 EMS period, suggesting that deviations from PPP are persistent under the EMS. Edison and Fisher (1991) conclude that the realignments of the EMS have not served fully to offset the inflation differentials

TABLE 1. Dates of realignments.

No.	Realignment date
0.	March 13, 1979
1.	September 24, 1979
2.	November 30, 1979
3.	March 23, 1981
4.	October 5, 1981
5.	February 22, 1982
6.	June 14, 1982
7.	March 21, 1983
8.	May 18, 1983
9.	July 22, 1985
10.	April 7, 1986
11.	August 4, 1986
12.	January 12, 1987
13.	January 8, 1990

No. 0 indicates the date of the initial formation of the EMS.

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