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Deviations from purchasing power parity: causes and welfare costs

Charles Engel^{a,*}, John H. Rogers^b

^a*Department of Economics, University of Wisconsin, Madison, WI 53706-1393, USA and NBER, Cambridge, MA 02138, USA*

^b*International Finance Division, Stop 22, Board of Governors of the Federal Reserve System, Washington, DC 20551, USA*

Abstract

We explore deviations from short-run purchasing power parity (PPP) across European cities, attempting to move beyond a ‘first-generation’ of papers that document very large border effects. We document two very distinct types of border effects embedded in relative prices. The first is a ‘real barriers effect’, caused by various barriers to market integration. The second is a sticky-consumer-price cum volatile exchange-rate effect. Both are shown to be important empirically, the second type especially so. We argue that the two effects are very different from each other. For the first type of effect, it is clear that border effects imply deadweight welfare losses. We argue that while the second type of border effect could be eliminated with fixed exchange rates, welfare is not necessarily increased. © 2001 Elsevier Science B.V. All rights reserved.

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1. Introduction

A spate of recent research has improved our understanding of the magnitude, sources, and implications of the well-documented deviations from the law of one

*Corresponding author. Tel.: +1-206-543-6197; fax: +1-206-685-7477.

E-mail addresses: cengel@ssc.wisc.edu (C. Engel), john.h.rogers@frb.gov (J.H. Rogers).

price internationally (Isard, 1977). One strand of the literature estimates half-lives of real exchange rates. For most countries and time periods, real exchange rates are found to be highly persistent, with deviations from PPP among industrialized nations having half lives of 3 to 4 years.¹ Another strategy has been to compare movements in goods prices across national borders to price movements between different regions within a country. Engel and Rogers (1996) (hereafter referred to as ER) demonstrate that prices of similar goods between US and Canadian cities are systematically more variable than prices between equidistant cities in the same country. By this ‘width of the border’ metric, international failures of the law of one price are large. The ER finding is consistent with other research showing that goods, labor, and capital flow more readily between regions within a country than across borders (see McCallum (1995) and papers in the volume edited by Hess and van Wincoop (1999)).

Several insights have also been brought to bear on the possible sources of these failures of the law of one price. The potential sources include tariffs and non-tariff barriers to trade, transportation costs, non-traded inputs such as marketing and other distribution services that are a part of final goods prices, and variable nominal exchange rates under sticky prices. One explanation of this last source is that producers selling abroad set prices in the currency of consumers rather than their own. Under local currency pricing (LCP), changes in nominal exchange rates do not affect goods prices in the local market, i.e. there is zero pass-through of exchange rate changes. Several papers present evidence of local currency pricing, including Giovannini (1988), Marston (1990), and Knetter (1993). Feenstra and Kendall (1997) find that a significant portion of observed deviations in the law of one price is attributable to incomplete exchange rate pass-through as a result of local currency pricing. Our results are consistent with Feenstra and Kendall’s.

Interest in the extent to which local currency pricing can account for empirical failures of the law of one price has surged for two related reasons. Firstly, with the launching of the Euro on January 1, 1999 the currencies of European Monetary Union members became irrevocably fixed on their way toward eventually disappearing from circulation. Across the Atlantic, advocates of a ‘dollar bloc’ have recently proposed that some combination of Argentina, Mexico, Ecuador and Canada relinquish their national currencies and adopt the US dollar. This would replace current arrangements that have produced different degrees of exchange rate flexibility, as did EMU. There have also been calls for a Japanese yen bloc in Asia. Deviations from the law of one price would be reduced under such unified currency blocs if local currency pricing is indeed a significant factor.

Secondly, several recent theoretical papers have argued that assumptions concerning price-setting behavior can affect the debate about the merits of fixed versus floating exchange rate systems. Engel (2000) and Devereux and Engel

¹See Rogoff’s (1996) survey for references to this voluminous literature.

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