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On cross-country differences in the persistence of real exchange rates

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Abstract

Previous findings of long-run purchasing power parity come mainly from data for industrial countries, raising the issue of whether the results suffer sample-selection bias and exaggerate the general relevance of parity reversion. This study uncovers substantial cross-country heterogeneity in the persistence of deviations from parity. The results show that it is more likely, rather than less likely, to find parity reversion for developing countries than industrial countries. Although some persistence variations may partly reflect country differences in structural characteristics such as inflation experience and government spending, a considerable portion of those variations seems unaccounted for. © 2000 Elsevier Science B.V. All rights reserved.

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1. Introduction

Arguing that the post-Bretton Woods period may be far too short to reveal PPP reversion, many studies explore long historical data and find evidence of parity reversion in real exchange rates (e.g., Abuaf and Jorion, 1990; Cheung and Lai,

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1993; Culver and Papell, 1995; Diebold et al., 1991; Glen, 1992; Lothian and Taylor, 1996). The long-horizon approach, however, is susceptible to specific sample-selection bias, referred to as survivorship bias (Froot and Rogoff, 1995). Because of data availability, long-horizon studies of PPP investigate primarily industrial countries. In contrast, empirical evidence on PPP for developing countries is notably limited. For countries undergoing significant income growth from a low level, relative prices of tradables and nontradables can change substantially, inducing nonstationarity in real exchange rate dynamics. As a result, parity reversion may likely fail to work for this type of countries. A question has been raised about whether existing results from long-horizon studies, given their focuses on major industrial countries, may overstate the general significance of empirical support for long-run PPP. Clearly, economists like to use PPP as a frame of reference not just for industrial countries, but for the rest of the world as well. To resolve the issue apparently requires a large-scale study of different types of countries.

This study evaluates the significance of survivorship bias in PPP analysis by conducting an extensive time-series analysis of the persistence in dollar-based real exchange rates for 94 countries. Several related questions of interest are: Does the behavior of real exchange rates indeed differ between developing countries and industrial countries? If it does, is it less or more likely to find stationarity in real exchange rates for developing countries than industrial countries? Do the results based on industrial countries exaggerate the actual extent of empirical support for parity reversion?

The potential survivorship bias highlights a more basic issue concerning possible differences in the behavior of real exchange rates among countries or groups of countries. If the cross-country differences are substantial, empirical modeling of real exchange rate dynamics should take such cross-sectional heterogeneity into account and consider countries individually. Three different forms of parity-reverting dynamics are allowed for in this study; they include persistent autoregressive (AR) dynamics, persistent fractional dynamics, and trend-break/stationary dynamics. In doing this, the analysis permits diverse rates of parity reversion across real exchange rates.

The allowance for different reverting dynamics under the alternative hypothesis also addresses a commonly known problem associated with generic unit-root tests, namely, their low power against relevant stationary alternatives (Stock (1994) provides an excellent survey of the related issues). The three types of alternatives entertained here have been considered, albeit separately, in some earlier PPP studies to account for the empirical difficulty in detecting parity reversion (see Cheung and Lai (1998b) for testing of persistent AR dynamics; Cheung and Lai (1993) and Diebold et al. (1991) for fractional analysis; and Cheung and Lai (1998a) and Culver and Papell (1995) for trend-break analysis). To be sure, there are theoretical reasons to suggest that allowing for persistent alternatives is desirable. For example, intertemporal smoothing of traded goods consumption

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