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Economics Letters 83 (2004) 313–316
economics letters
www.elsevier.com/locate/econbase

Are Asian real exchange rates stationary?

Venus Khim-sen Liew[a], Ahmad Zubaidi Baharumshah[a], Terence Tai-leung Chong[b,*]

[a] *Department of Economics, Faculty of Economics and Management, Universiti Putra Malaysia, 43400 UPM Serdang, Selangor, Malaysia*

[b] *Department of Economics, The Chinese University of Hong Kong, Shatin, N. T., Hong Kong*

Received 28 May 2003; accepted 21 October 2003

Abstract

By applying the newly developed nonlinear stationary test advanced by Kapetanios et al. [Journal of Econometrics 112 (2003) 359] in examining the stationary property of 11 Asian real exchange rates, this paper rejects unit root in 8 US dollar-based and 6 Japanese yen-based rates, whereas the augmented Dickey–Fuller (ADF) test has led to no rejection at all.

JEL classification: F31

Keywords: Real exchange rates; Asia; Mean reversion; Nonlinear stationary test; ADF test

1. Introduction

The stationarity of real exchange rate has been the major concern of exchange rate studies as it has few major implications in the international finance. A nonstationary real exchange rate indicates that there is no long run relationship between nominal exchange rate, domestic and foreign prices, thereby invalidating the purchasing power parity (PPP) hypothesis. As such, PPP cannot be used to determine the equilibrium exchange rate, a position in which most policy makers are interested to know. Invalid PPP also disqualifies the monetary approach to exchange rate determination, which requires PPP to hold true.

Another implication of nonstationarity in real exchange rate is that unbounded gains from arbitrage in traded goods are possible (Kapetanios et al., 2003, henceforth, KSS). In fact, Parikh and Williams (1998)

* Corresponding author. Tel.: +852-2609-8193; fax: +852-2603-5805.
E-mail address: chong2064@cuhk.edu.hk (T.T. Chong).

0165-1765/$ - see front matter
doi:10.1016/j.econlet.2003.10.021