

NONLINEAR MEAN REVERSION IN REAL EXCHANGE RATES: EVIDENCE FROM THE ASEAN-5[§]

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Abstract

Utilizing formal nonlinear unit root test (Sarno, The behavior of US public debt: a nonlinear perspective. *Economics Letters* 2001: 119 – 125), this study provides robust evidence of nonlinear mean reversion in the real exchange rates of 4 major ASEAN countries. We conclude that the bulk of the evidence based on conventional unit root tests may be biased against long run Purchasing Power Parity (PPP)

Keywords: Purchasing power parity; Real exchange rate; ASEAN; Nonlinear unit root test; STAR model.

JEL classification: F31, F32

1. Introduction

A number of recent empirical studies have provided evidence that the behavior of exchange rate is in fact nonlinear in nature (Micheal et al., 1997; Taylor and Peel; 1997; Sarno, 1998; Sarno, 2000a,b; Sarantis, 1999; Taylor and Peel; 2000; Baum et al., 2001; Liew et al., 2002). Through performing formal linearity test procedure (Lukkonen et al., 1988; Granger and Terasvirta, 1993) these studies have found enough evidence to reject the null of linearity in empirical exchange rate series. In particular, most of these studies conclude that exchange rate adjustment varies nonlinearly with respect to the size of

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