Nonlinear Adjustment Purchasing Power Parity Deviations of ASEAN Exchange Rates

1. Introduction

The purchasing power parity (PPP) relationship has been the forefront of modern international finance. The hypothesis posits a stable long-run relationship between nominal exchange rate and relative price levels. Of late, studies on PPP have appeared in abundance in the literature. In a comprehensive survey, Froot and Rogoff (1995) declared that what was a 'fairly dull research topic' only a decade ago has recently been the focus of substantial controversy and the subject of growing body of literature. The bulk of the empirical research based on pure time series analysis and over the span of 25 years or so (post-Bretten Woods era) failed to support long-run PPP hypothesis: real exchange rate followed a random walk, with no mean-reversion property. It is now well known that conventional unit root tests have low power using short-series data. The response of researchers (Cuddington and Hong, 2000; Glens, 1992; Lothian and Taylor, 1996; M-Azali et al., 2001, to name a few) was to expand the size of sample either using longer time-series (more than a centaury) or combining cross-section with time series--panel approach.

Despite of the progress made from exploiting more data and higher-power techniques, the empirical evidence on long-run PPP hypothesis obtained from these research efforts have been mixed. Studies by Lothian and Taylor (1996), Nagayasu (1998), M-Azali et al. (2001), for example, are supportive of long-run PPP hypothesis. On the