PPP Strikes Back: Aggregation and the Real Exchange Rate

IMBS Jean, MUMTAZ Haroon, RAVN Morten O., REY Hélène

We show the importance of an aggregation bias in accounting for the PPP puzzle. We prove that established time series and panel methods substantially exaggerate the persistence of real exchange rates because of heterogeneity in the dynamics of disaggregated relative prices. When heterogeneity is properly taken into account, estimates of the real exchange rate half-life fall dramatically, to little more than one year, or significantly below Rogoff's "consensus view" of three to five years. We show corrected estimates are consistent with plausible nominal rigidities, thus, arguably, solving the puzzle. We also explain why traded goods prices account for the bulk of the persistence and volatility of the real exchange rate. The reason is that traded goods prices display dynamics that are more heterogeneous than non-traded ones.

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