

What Remains of Purchasing Power Parity?

Kenneth Rogoff*
Princeton University

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Abstract

In recent years there has been a tremendous resurgence of interest in empirical work on purchasing power parity and the law of one price. This paper provides an overview of recent developments, including the emerging consensus that deviations from PPP do damp out but only very slowly, at roughly fifteen percent per year. A number of real factors, including the Balassa-Samuelson effect, international price discrimination, differential government spending, and current account imbalances, appear to help explain medium-term deviations from PPP. However, a quandary remains. The high short-term volatility of real exchange rates is difficult to explain without appealing to monetary and financial shocks. But if these shocks are significant, then it is hard to explain why the estimated speed of convergence to PPP is so low.

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