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Purchasing Power Parity**

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## Abstract:

The persistence of aggregate real exchange rates is a prominent puzzle, particularly since adjustment of international relative prices in microeconomic data is much faster. This paper finds that adjustment to the law of one price in disaggregated data is not just a faster version of the adjustment to purchasing power parity in the aggregate data; while aggregate real exchange rate adjustment works primarily through the foreign exchange market, adjustment in disaggregated data is a qualitatively distinct process, working through adjustment in local-currency goods prices. These distinct adjustment dynamics appear to arise from distinct classes of shocks generating macro and micro price deviations. A vector error correction model nesting aggregate and disaggregated relative prices permits identification of distinct macroeconomic and good-specific shocks. When half-lives are estimated conditional on shocks, the macro-micro disconnect puzzle disappears: microeconomic relative prices adjust to macro shocks just as slowly as do aggregate real exchange rates. These results provide evidence against theories of real exchange rate behavior based on sticky prices and on heterogeneity across goods.

JEL classification: F4

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## **I. Introduction**

The persistence of aggregate real exchange rates as they converge back to some form of purchasing power parity is a longstanding puzzle. This is especially so, since recent research using microeconomic data sets has demonstrated that convergence to the law of one price by disaggregated international relative prices occurs at a much faster rate. Work by Imbs et al. (2005) has documented this puzzle, as well as proposing one explanation in which heterogeneity in the convergence speeds among goods can produce an upward aggregation bias.

This paper finds that the contrasting speeds of adjustment are only one part of the distinction between aggregated and disaggregated data. Adjustment to the law of one price in micro data is not just a faster version of the same adjustment process to PPP for aggregate data; adjustment in disaggregated data is a qualitatively distinct process, working through adjustment in local-currency goods prices rather than the nominal exchange rate.

The theory of purchasing power parity is ambiguous as to whether parity is attained primarily through arbitrage in the goods market that induces goods prices to adjust, or through forces in the foreign exchange market that induce the nominal exchange rate to adjust. For aggregate data, a number of papers applying time-series analysis to aggregate real exchange rates have found that most of the adjustment takes place through the nominal exchange rate (see Fisher and Park (1991) using cointegration analysis, Engel and Morley (2001) using a state-space analysis, and Cheung, Lai and Bergman (2004) using vector error-correction analysis). But if one wishes to investigate the role of arbitrage in the goods market, this paper argues that one should use price data on individual goods, where the arbitrage between home and foreign versions of a good should be expected to play out.

This study analyzes the relative adjustment of goods prices and the exchange rate using a large panel data set of prices at the individual good level. The data come from the Economist Intelligence Unit covering individual goods and services in cities worldwide, biannually from 1990 to 2007. We study a subset of these data for city pairs between the U.S. and 20 industrial countries. A

vector error correction model is estimated for each good, as well as for an aggregate price index constructed over the goods in the sample. We find that in disaggregated data, local goods prices actively adjust to restore the law of one price. However, when the micro-level data are aggregated into a synthetic representation of an aggregate real exchange rate, all adjustment to restore PPP takes place through nominal exchange rates. While the latter conclusion agrees with past work on aggregate data, the conclusion for disaggregated data appears to be at odds.

After ruling out measurement error as an explanation, we conjecture that the result is due to industry-level product shocks which are distinct from macroeconomic and foreign exchange market shocks at the aggregate level. These idiosyncratic goods shocks are volatile, and the responses to them dominate the aggregate shocks in the disaggregated data. But the idiosyncratic shocks cancel out upon aggregation, since some shocks to price differentials are positive, while others are negative. So the responses to exchange rate shocks dominate in the aggregated data.

To test this hypothesis, the paper estimates a combined vector error correction model that nests together the aggregate and disaggregated equations and data. We know of no one else who has studied disaggregated deviations from the law of one price jointly with aggregated deviations from purchasing power parity together in this way. A simple identification scheme allows us to identify the idiosyncratic shocks, as distinct from foreign exchange market shocks, and from other aggregate shocks.

Our results support the conjecture above. Variance decompositions indicate that while foreign exchange shocks dominate in aggregate data, industry-specific shocks dominate in disaggregated data. When adjustment speeds are estimated conditional by shock, the estimated half-lives are similar across aggregate and disaggregate data. This suggests that the reason that real exchange rate persistence differs at the macro and micro levels is that different shocks dominate in aggregated and disaggregated data.

One implication of this finding is that it argues against an explanation for the persistence puzzle based upon heterogeneity and aggregation bias. It also indicates that conventional estimates of adjustment speed in disaggregated data that do not distinguish between adjustment to aggregate components and idiosyncratic components are subject to an omitted variable bias. A second implication of this result regards the usefulness of sticky price models to explain real exchange rate behavior. A conventional understanding in this theoretical literature is that PPP deviations gradually decline as firms are able to reset prices in response to the macroeconomic shocks that created the PPP deviation. But our error correction results show that prices respond quite quickly to deviations from the law of one price, and our study of the resulting impulse responses show that price adjustment accounts for a large share of corrections to these deviations. A model that coincides better with the evidence would be a sticky information story, where firms adjust to shocks specific to their industry rather than common macroeconomic shocks. For example, Mackowiak and Wiederholt (forthcoming) show in a rational inattention model that, when idiosyncratic conditions are more variable or more important than aggregate conditions, it is optimal for firms to pay more attention to idiosyncratic conditions than to aggregate conditions.

Our work is also related to recent research by Crucini and Shintani (2008), who also use EIU price data to study LOP dynamics. Our paper differs in that, in addition to studying stationarity and convergence speeds, it focuses on studying the mechanism of adjustment with an error correction mechanism. It also differs in that we negotiated with EIU to get access to their historical data at a semi-annual frequency, doubling the length of time series. Our findings are also complementary to Broda and Weinstein (2008), who speculate that nonlinear convergence rates led to faster adjustment among disaggregated price deviations because they are dominated by large outliers. Our findings suggest an alternative mechanism, based not on outliers, but on the distinction between idiosyncratic industry shocks and macroeconomic shocks.

The next section discusses the data set and data characteristics, including stationarity and speeds of convergence. Section 3 presents results for a series of vector error correction models studying the separate contributions of price and exchange rate adjustment. Section 4 concludes with implications for the broader literature on real exchange rates.

## II. Data and Preliminary Analysis

Data are obtained from the *Worldwide Cost of Living Survey* conducted by the Economist Intelligence Unit (EIU), which records local prices for individual goods and services in cities worldwide.<sup>1</sup> The data are available from 1990 to 2007. To facilitate analysis of the time-series dynamics of the panel, we were able to obtain from the EIU the historical observations twice-annually, rather than the annual data previously released to the public.

The goods are narrowly defined, e.g. apples (1 kg), men's raincoat (Burberry type), and light bulbs (2, 60 watt). For many goods in the survey, prices are sampled separately from two different outlets, a "high-price" and "low-price" outlet. For example, food and beverage prices are sampled from supermarkets and convenience stores. We use prices from the supermarket type outlets, which are likely to be more comparable across cities. The data set also includes many service items such as telephone and line, moderate hotel (single room), and man's haircut, which would most naturally be classified as non-tradable. All prices are recorded in local currency and converted into dollars.

We focus on bilateral prices between the major city in each of 20 industrial countries relative to the United States. The choice of countries reflects those used in past work on price aggregates (such as in Mark and Sul (2008)), and the choice of cities reflects that in Parsley and Wei (2002).<sup>2</sup>

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<sup>1</sup> The EIU survey is used to calculate cost-of-living indexes for multinational corporations with employees located around the world. The data set is described in more detail at [http://eiu.enumerate.com/asp/wcol\\_HelpAboutEIU](http://eiu.enumerate.com/asp/wcol_HelpAboutEIU).

<sup>2</sup> Mark and Sul (2008) use the data from Imbs et al. (2005) for 19 goods in 10 European countries and the U.S.; we augment the data with more industrial countries to increase the power to reject unit roots in panel estimation. eeeeeeeeeeeeeeeeeeeeeestimation estimation.

For these locations, the data set has full coverage for 98 tradable goods and 30 nontraded goods, as identified by Engel and Rogers (2004) in their study of price dispersion in Europe.<sup>3</sup> Appendix Tables A1, A2, and A3 list the cities and goods included in the analysis.

Define  $q_{ij,t}^k$  as the relative price of good  $k$  between two locations  $i$  and  $j$ , in period  $t$ , in logs.

This may be computed as  $q_{ij,t}^k = e_{ij,t} + p_{ij,t}^k$ , where  $e_{ij,t}$  is the nominal exchange rate (currency  $j$  per currency  $i$ ), and  $p_{ij,t}^k = p_{i,t}^k - p_{j,t}^k$  is the log difference in the price of good  $k$  in country  $i$  from that in country  $j$ , both in units of the local currency. As preparation for the main analysis later, we first establish that the international relative prices are stationary. We apply the cross-sectionally augmented Dickey-Fuller (CADF) test provided by Pesaran (2007) to examine the stationarity of variables. The advantage of this test is that it controls for contemporaneous correlations across residuals. Consider the following regression:

$$\Delta q_{ij,t}^k = a_{ij}^k + b_{ij}^k (q_{ij,t-1}^k) + c_{ij}^k (\bar{q}_{t-1}^k) + d_{ij}^k (\Delta \bar{q}_t^k) + \varepsilon_{ij,t}^k \quad (1)$$

$$ij = 1, \dots, N, k = 1, \dots, K, \text{ and } t = 1, \dots, T$$

where  $\bar{q}_t^k = \sum_{ij=1}^N q_{ij,t}^k$  is the cross-section mean of  $q_{ij,t}^k$  across country pairs and  $\Delta \bar{q}_t^k = \bar{q}_t^k - \bar{q}_{t-1}^k$ .

The purpose for augmenting the cross-section mean in the above equation is to control for contemporaneous correlation among  $\varepsilon_{ij,t}^k$ . The null hypothesis of the test can be expressed as

$H_0 : b_{ij}^k = 0$  for all  $ij$  against the alternative hypothesis  $H_1 : b_{ij}^k < 0$  for some  $ij$ . The test statistic

provided by Pesaran (2007) is given by:

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<sup>3</sup> Engel and Rogers (2004) included only goods for which a price is recorded in every year for at least 15 of the 18 European cities in their analysis. The dataset used by Parsley and Wei (2002) contains 95 traded goods. Their set is virtually identical to that of Engel and Rogers (2004), with the difference that Parsley and Wei include yogurt, cigarettes (local brand), cigarettes (Marlboro), tennis balls, and fast food snacks, but exclude butter, veal chops, veal fillet, veal roast, women's raincoat, girl's dress, compact disc, color television, international weekly newsmagazine, paperback novel, and electric toaster. Engel, Rogers, and Wang also use EIU data.

$$CIPS^k(N, T) = N^{-1} \sum_{ij=1}^N t_{ij}^k(N, T)$$

where  $t_{ij}^k(N, T)$  is the t statistic of  $b_{ij}^k$  in equation (1).

The top panel of Table 1 indicates rejection of nonstationarity at the 5% significance level for the large majority of traded goods, 72 at 10%, 63 at 5%, out of 98 traded goods in the sample.

Among nontraded goods, rejection at the 5% level is supported for 11 at both 5% and 10% out of the 30 goods-- less strong than for tradeds. In addition to studying the behavior of the individual goods prices, we can also study aggregate prices, constructed as a simple average over the goods:

$$q_{ij,t} \equiv \sum_{k=1}^K q_{ij,t}^k .$$

This constructed aggregate provides a useful comparison to the large body of past

studies of persistence in real exchange rates.<sup>4</sup> The bottom panel of Table 1 shows that nonstationarity can be rejected at the 1% level for the average over all traded goods. For an average over just nontraded goods, nonstationarity cannot be rejected. In the remainder of the paper, we will focus on the set of traded goods, for which there is stronger evidence of stationarity.

Next, we check the speed of convergence toward stationarity by estimating a second-order autoregressive model of real exchange rates with panel data.<sup>5</sup> To control for contemporaneous correlation of residuals, we apply the common correlated effects (CCE) regressor of Pesaran (2006) to estimate the autoregressive coefficients of real exchange rates. In other words, we estimate the equation:

$$q_{ij,t}^k = c_{ij}^k + \sum_{m=1}^2 \rho_{ij,m}^k (q_{ij,t-m}^k) + \varepsilon_{ij,t}^k \text{ for } k = 1, \dots, K \quad (2)$$

for disaggregated data and

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<sup>4</sup> In principle, we could also assign weights to the goods derived loosely from weights in a country's CPI. However, Crucini and Shintani (2008) find that alternative weighting schemes do not affect results for this test.

<sup>5</sup> Inclusion of additional lags is precluded by the short time-span of the data set.

$$q_{ij,t} = c_{ij} + \sum_{m=1}^2 \rho_{ij,m} (q_{ij,t-m}) + \varepsilon_{ij,t} \quad (3)$$

for aggregated data, each augmented with cross-section means of right and left hand side variables. Two different CCE estimators are proposed by Pesaran (2006). One is the mean group estimator, CCEMG, and the other one is the standard pooled version of CCE estimator, CCEP. Pesaran's (2006) monte-carlo simulation results show that, under the assumption of slope heterogeneity, CCEP and CCEMG have the correct size even for samples as small as  $N = 30$  and  $T = 20$ . We adopt the CCEP estimator in our empirical analysis. Both methods deliver broadly similar results here. CCEP estimates are obtained by regressing equations (2) and (3) with augmented regressors  $(\bar{q}_t^k, \bar{q}_{t-1}^k, \bar{q}_{t-2}^k)$  and  $(\bar{q}_t, \bar{q}_{t-1}, \bar{q}_{t-2})$ , respectively.

Results in Table 2 indicate quick convergence speeds for disaggregated goods, with an average half-life among the goods of 1.25 years. Half-lives are computed on the basis of simulated impulse responses<sup>6</sup>. Adjustment for the aggregate data is distinctly slower, with a half-life of 2.10 years.<sup>7</sup> Since the second order autoregressive coefficients are not statistically significant, we also estimate a first-order autoregression, with results in the table. The conclusion is similar, with the half-life about double in aggregated data compared to the average among disaggregated data, 2.13 years compared to 1.15. The fact that half-lives at the disaggregated level are faster than for aggregates reflects the finding of Imbs et al. (2005) with their data set. They hypothesize an explanation, based on the idea that speeds of adjustment are heterogeneous among goods, and that

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<sup>6</sup> The half-life is computed as the time it takes for the impulse responses to a unit shock to equal 0.5, as defined in Steinsson (2008). We identify the first period,  $t_1$ , where the impulse response  $f(t)$  falls from a value above 0.5 to a value below 0.5 in the subsequent period,  $t_1+1$ . We interpolate the fraction of a period after  $t_1$  where the impulse response function reaches a value of 0.5 by adding  $(f(t_1) - 0.5) / (f(t_1) - f(t_1+1))$ .

<sup>7</sup> Previous literature has tended to find even larger half-lives in aggregated data, commonly exceeding 3 years. The somewhat smaller half-life in our aggregated data reflects primarily the shorter sample, starting in 1990, and the broader set of countries, 20 industrial. When we compute standard CPI-based real exchange rates from IFS data for our sample of countries and years, the half-life is estimated at 2.07 years, very similar to that of the synthetic aggregated constructed over our set of goods reported above. Extending the sample back to 1975, results in a half life estimate of 3.34

aggregation tends to give too much weight to goods with slow speeds of adjustment and hence long half-lives. The implications of our data for this hypothesis will be discussed at greater length in the following sections.

### III. Results

#### A. Error Correction Puzzle

This section investigates the engine of convergence to the law of one price and identifies a new puzzle. The stationarity of real exchange rates implies the cointegration of nominal exchange rates ( $e_{ij,t}$ ) and relative prices ( $p_{ij,t}$ ) with the cointegrating vector being (1, 1). We now turn our attention to the dynamics of the adjustment of nominal exchange rates and relative prices based on the following panel error correction model (ECM):

$$\Delta e_{ij,t}^k = \alpha_{ij,e}^k + \rho_{e,ij}^k (q_{ij,t-1}^k) + \mu_{e,ij}^k (\Delta e_{ij,t-1}^k) + \mu_{e,ij}^k (\Delta p_{ij,t-1}^k) + \zeta_{ij,t}^{e,k} \quad (4)$$

$$\Delta p_{ij,t}^k = \alpha_{ij,p}^k + \rho_{p,ij}^k (q_{ij,t-1}^k) + \mu_{p,ij}^k (\Delta e_{ij,t-1}^k) + \mu_{p,ij}^k (\Delta p_{ij,t-1}^k) + \zeta_{ij,t}^{p,k} .^8$$

To allow for possible cross section dependence in the errors, we computed CCEP estimators of the parameters. The CCEP estimates are obtained by regressing both changes in the nominal exchange rate and the ratio of prices on lagged deviations from the law of one price ( $q_{ij,t-1}^k$ ), lagged changes in the nominal exchange rate and the ratio of prices, along with cross section averages ( $(\bar{q}_{t-1}^k, \Delta \bar{p}_{t-1}^k, \Delta \bar{e}_t^k$  and  $\Delta \bar{e}_{t-1}^k)$  and  $(\bar{q}_{t-1}^k, \Delta \bar{p}_t^k, \Delta \bar{p}_{t-1}^k$  and  $\Delta \bar{e}_{t-1}^k)$  for the  $\Delta e_{ij,t}^k$  and  $\Delta p_{ij,t}^k$  equations, respectively).

The coefficients  $\rho_{e,ij}^k$  and  $\rho_{p,ij}^k$  reflect a measure of the speed of adjustment of nominal exchange rates and relative prices, respectively, to a deviation from the law of one price. This pair of ECM equations is estimated for our panel of city pairs, for each of the 98 traded goods, as well as for

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<sup>8</sup> Because this error correction model incorporates lags of first differences to capture short-run dynamics, this specification is analogous to the second-order autoregression estimated previously. Inclusion of additional lags is impossible due to the short time-span of the data set.

aggregates over these goods.

As a basis of comparison with past research, we consider first the constructed aggregate prices. Recall that Fisher and Park (1991) found for aggregate CPI-based real exchange rates that the speed of adjustment is significant for exchange rate and insignificantly different from zero for price, concluding that adjustment takes place primarily through the exchange rate. Our method of estimating the error correction mechanism differs from theirs, pooling across countries with panel data for each equation in (4), but our conclusion for aggregate data agrees with theirs. The speed of adjustment for price is just 0.04, while that for the exchange rate is much larger 0.13. Due to our panel methodology, both coefficients are statistically significant, so we cannot conclude that the price coefficient equals zero as found in past work. But the much larger coefficient (in absolute value) in the exchange rate equation indicates that the exchange rate responds much more strongly than does price.<sup>9</sup>

The result is entirely different at the disaggregated goods level. Now we estimate the error correction regression (4) as a panel over city pairs, once for each of the traded goods in the sample. Table A4 in the appendix shows results for each good separately, and Table 3 summarizes by reporting median values over the goods. The role of the two variables is reversed from that of the aggregates: the mean speed of adjustment for the price ratio is large, 0.20, while that for the exchange rate is much smaller, 0.03. Looking at goods individually, 87 out of the 98 goods have a price response that is statistically significant at the 5% level, whereas only 54 goods have a statistically significant response for the exchange rate. At the 1% level, 75 goods have significant price responses but only 35 have significant exchange rate responses.

Judging by speeds of adjustment, the dynamic adjustment appears to be very different at the disaggregated level than at the aggregated level. While at the aggregate level it is nominal exchange

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<sup>9</sup> Because the two equations in (4) are estimated individually, we do not have the joint distribution of response coefficients needed to conduct a formal F test.

rate movements that facilitate dynamic adjustment to restore PPP, at the disaggregated level it is movements in the price in the goods market that does the adjustment. It probably should not be surprising that the nominal exchange rate cannot serve the function of adjustment for individual goods, given Crucini et al. (2005) has showed that for European country pairs there are many goods overpriced as well as underpriced. The same appears to be true for our country pairs. Given that adjustment requires movements in opposite directions for these two groups of goods, there is no way that the exchange rate component of these relative prices can make them move in the necessary directions simultaneously. However, what is surprising is that goods prices do facilitate adjustment at the goods level, and in fact adjustment is faster than for aggregate prices that have the exchange rate to move them.

To check the sensitivity of our result to our particular data set, we conduct the same error correction estimation using the data set used by Imbs et al. (2005).<sup>10</sup> While the values of adjustment parameters reported in Table 4 are lower across the board, the pattern of relative rankings is the same. In disaggregated industry level data the speed of adjustment for prices is more than twice that for the nominal exchange rate; for aggregated data the reverse is true, with the speed of adjustment for prices being half of that for the nominal exchange rate.

## **B. Explanations for the Puzzle**

This section explores potential explanations for the error correction puzzle identified above. How can it be that the dynamics of the disaggregated relative price deviations are qualitatively different from the aggregate relative price dynamics, since the latter by definition is the summation of the former? The first thing to rule out is measurement error in the disaggregated price observations. This would seem plausible, given that the price ratio data rely upon survey takers to

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<sup>10</sup> The Imbs et al. (2005) benchmark dataset we use consists of monthly observations extending from 1981 to 1995 for the U.S. and 10 European countries (we exclude Finland in order to maintain a balanced panel, as required for our estimation methodology).

subjectively choose representative goods within some categories. If the measurement error is corrected or reversed in subsequent observations of prices, it might appear as if prices are adjusting to correct the price deviation. (Of course, the exchange rate data would not be subject to the errors of survey collection.) To test this explanation, a Hausman test is conducted, estimating a first-order autoregression of  $q_{ij,t}^k$  for each cross-sectional item (country-goods) by two methods, OLS and two stage least squares using lagged values as instruments, and testing if the OLS estimate is consistent. Among the 1843 country-good series, only 233 reject consistency at the 5% level. This indicates that measurement error is not a problem for most of our observations.

Another potential explanation for our result is that the type of aggregation bias Imbs et al. (2005) described for autoregressions, like our equation (2), could have an analog for our error correction equation (3). Imbs et al. (2005) argued that heterogeneity in the speeds of convergence in the real exchange rate among disaggregated goods can lead to an overestimate of the persistence in the aggregate real exchange rate, under conditions where those goods with slow speeds of adjustment receive too much weight in computing the aggregate price level.<sup>11</sup> To translate this argument into an explanation for our error correction estimation, aggregation would need to lead to a bias underestimating the aggregate adjustment speed in one variable, the prices, but at the same time an overestimate of the speed of adjustment in another variable, the nominal exchange rate. On one hand, we can confirm that there is heterogeneity among the goods  $k$  in terms of the size of  $\rho_e^k$  and  $\rho_p^k$ , so larger weights on some goods could lead to estimates of the aggregate that are different from the average among the goods. However, there is no heterogeneity among goods in terms of the fact that  $|\rho_e^k| < |\rho_p^k|$ ; this is true for all 98 of the goods in the sample. We can conceive of no weighting of goods when aggregating that could reverse this inequality in the aggregate.

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<sup>11</sup> This argument has been critiqued by Chen and Engel (2005) among others.

Finally, we investigate what we think is the most likely explanation for our main result. We conjecture that there are idiosyncratic shocks at the good level that are distinct from macroeconomic shocks occurring at the aggregate level. These idiosyncratic shocks are volatile, and the responses to them dominate the aggregate shocks in the disaggregated data. But the idiosyncratic shocks cancel out upon aggregation, since some are positive shocks while others are negative. So the responses to aggregate shocks dominate in the aggregated data.

To test this hypothesis, we estimate a modified three-variable vector error correction model, which combines aggregate and disaggregated price data series:

$$\begin{aligned}
\Delta e_{ij,t}^k &= \alpha_{ij,e}^k + \rho_{e,ij}^{k1} (q_{ij,t-1}^k - q_{ij,t-1}) + \rho_{e,ij}^{k2} (q_{ij,t-1}) \\
&\quad + \mu_{e,ij,1}^k (\Delta e_{ij,t-1}^k) + \mu_{e,ij,2}^k (\Delta p_{ij,t-1}^k) + \mu_{e,ij,3}^k (\Delta p_{ij,t-1}) + \zeta_{e,ij,t}^k \\
\Delta p_{ij,t} &= \alpha_{p,ij}^k + \rho_{p,ij}^{k1} (q_{ij,t-1}^k - q_{ij,t-1}) + \rho_{p,ij}^{k2} (q_{ij,t-1}) \\
&\quad + \mu_{pkij,1}^k (\Delta e_{ij,t-1}^k) + \mu_{p,ij,2}^k (\Delta p_{ij,t-1}^k) + \mu_{p,ij,3}^k (\Delta p_{ij,t-1}) + \zeta_{p,ij,t}^k \\
\Delta p_{ij,t}^k &= \alpha_{pk,ij}^k + \rho_{pk,ij}^{k1} (q_{ij,t-1}^k - q_{ij,t-1}) + \rho_{pk,ij}^{k2} (q_{ij,t-1}) \\
&\quad + \mu_{pk,ij,1}^k (\Delta e_{ij,t-1}^k) + \mu_{pk,ij,2}^k (\Delta p_{ij,t-1}^k) + \mu_{pk,ij,3}^k (\Delta p_{ij,t-1}) + \zeta_{pk,ij,t}^k
\end{aligned} \tag{5}$$

There are two cointegrating vectors in this system over the variables  $e$ ,  $p^k$ , and  $p$ :  $[1 \ 0 \ 1]$  and  $[0 \ 1 \ -1]$ .

This system allows for a distinct response to the aggregate price deviation  $q_{ij,t-1}$ , which is the average across all goods, and a distinct response to the purely idiosyncratic price wedge, specified as  $q_{ij,t-1}^k - q_{ij,t-1}$ , the difference between the price wedge for one good and the average wedge across all goods. Given the definition of  $q$  and  $q^k$ , the latter difference alternately may be written:

$q_{ij,t-1}^k - q_{ij,t-1} = p_{ij,t-1}^k - p_{ij,t-1}$ . We know of no one else who has studied disaggregated deviations from the law of one price jointly with aggregated deviations from purchasing power parity together in this way.

Estimates of the response parameters in the expanded VECM, reported in Table 5, support and extend the results found earlier when estimating separate VECM systems for aggregates and disaggregated data. Again  $p_k$  responds to  $q^k - q$  ( $p^k - p$ ) deviations, and now we see explicitly that it does not respond to  $q$  deviations. We see that  $e$  responds to aggregate  $q$  deviations but not to  $q^k - q$  ( $p^k - p$ ) deviations. And finally,  $p$  responds only to  $q$  deviations.

The main benefit of estimating equation (5) is that it provides a way to identify idiosyncratic shocks as separate from macroeconomic shocks. We use a Cholesky ordering of the variables  $e$ ,  $p$ , and  $p^k$ , which defines an industry shock as an innovation to  $p^k$  for a particular good that has no contemporaneous effect on aggregate  $p$  (or  $e$ ). We believe this is a case where a Cholesky identification of shocks is particularly well suited. An aggregate shock is one that makes both  $p^k$  and  $p$  move contemporaneously, as it affects goods prices on average. If desired, these aggregate shocks may be divided into shocks to the foreign exchange market, identified as all innovations to  $e$ , or shocks to the aggregate goods market, identified as innovations to  $p$  with no contemporaneous effect on  $e$ . This estimation is run for each of the 98 goods, and variance decompositions and impulse responses are generated for each.

Figures 1 and 2 report the variance decompositions of the variables by shock, where the numbers reported for disaggregated data are the averages among the 98 goods. Not surprisingly, variation in the aggregate real exchange rate,  $q$ , is due mainly to nominal exchange rate shocks, accounting for over 80% of variation, with a secondary role played by aggregate price shocks, and virtually no role at all played by idiosyncratic shocks. In contrast, variation in LOP deviations in disaggregated data,  $q^k$ , are due largely to idiosyncratic industry price shocks to  $p^k$ , accounting for about 80% of variation, with exchange rate shocks playing a much lesser role.

Impulse responses reported in Figures 3-5 help identify the mechanisms of adjustment. The figures report impulse responses from simulations of the system (5), where parameter values are the averages of the estimates derived for the 98 goods. Recall from the variance decompositions above

that most movements in  $q^k$  appear to be due to idiosyncratic shocks. The bottom panel of Figure 3 shows that the dynamics of  $q^k$  resemble that for  $p^k$ , whereas the nominal exchange does not move. Since  $q^k = e + p^k$ , this observation suggests that the goods price does most of the adjusting to restore LOP. Next, recall from variance decompositions that most of the movements in the real exchange rate,  $q$ , were due to nominal exchange rate shocks, with aggregate price shocks in a secondary role. The top panel of Figure 4 shows that the response of  $q$  to exchange rate shocks looks like that of the  $e$  component; this indicates the nominal exchange rate does the adjusting. Interestingly, for an aggregated price shock, the top panel of Figure 5 shows that the response of  $q$  looks like  $e$ ; again, the nominal exchange rate does most of the adjusting, even though the shock was an innovation to  $p$  orthogonal to innovations to  $e$ .

These conclusion regarding adjustment dynamics are formalized in Table 6 following the methodology of Cheung et al. (2004). Defining the impulse response of variable  $m$  to shock  $n$  as  $\psi_{m,n}(t)$ , note that  $\psi_{q_k,n}(t) = \psi_{e,n}(t) + \psi_{p_k,n}(t)$  for disaggregated data and  $\psi_{q,n}(t) = \psi_{e,n}(t) + \psi_{p,n}(t)$  for aggregated data. Then  $g_{e,n}^{q_k}(t) = \Delta\psi_{e,n}(t) / \Delta\psi_{q_k,n}(t)$  measures the proportion of adjustment in LOP deviations explained by nominal exchange rate adjustment, and  $g_{p_k,n}^{q_k}(t) = \Delta\psi_{p_k,n}(t) / \Delta\psi_{q_k,n}(t)$  measures the proportion explained by price adjustment, such that  $g_{e,n}^{q_k}(t) + g_{p_k,n}^{q_k}(t) = 1$ . The analogs for decomposing adjustment for aggregated data are  $g_{e,n}^q(t) = \Delta\psi_{e,n}(t) / \Delta\psi_{q,n}(t)$  and  $g_{p,n}^q(t) = \Delta\psi_{p,n}(t) / \Delta\psi_{q,n}(t)$ . The values in Table 6 support the conclusions above. Adjustment of aggregated data takes place mainly via adjustment in the nominal exchange rate regardless of shock. Adjustment of disaggregated data depends upon the shock; for aggregate shocks ( $e$  and  $p$ ), adjustment takes place mainly via nominal exchange rate adjustment, but for idiosyncratic shocks adjustment takes place via price adjustment.

Overall, we conclude that price deviations at the aggregate and disaggregated levels are very different. First they differ in terms of the shocks that drive them. Further, the dynamic responses differ according to shock: movements in disaggregated  $q_k$  are dominated by movements in the  $p^k$  component as it adjusts in response to  $p_k$  shocks, while movements in the aggregate  $q$  are dominated by movements in  $e$  adjusting in response to  $e$  and  $p$  shocks. This indicates to us that the apparent inconsistency in adjustment dynamics observed for aggregated and disaggregated data comes from the distinction between the particular shocks that dominate at different levels of aggregation.

### **C. Implications for the Convergence Speed Puzzle and Sticky Prices**

The hypothesis that different shocks and adjustment mechanisms are at work at different levels of aggregation also offers a promising explanation for the persistence puzzle popularized in Imbs et al. (2005) and others. Why does the half-life of aggregate real exchange rates appear to be so much longer than for disaggregated data? The error correction models estimated in the previous section provide an answer. Figures 3-5 indicates that the half-lives of disaggregated real exchange rates vary by the shock to which they are adjusting. Table 7 computes the half-life of adjustment of the aggregate and disaggregated real exchange rates, conditional on the shock.<sup>12</sup> The half-lives for aggregated real exchange rates,  $q$ , and disaggregated,  $q_k$ , are quite similar to each other when conditioned on aggregate  $e$  and  $p$  shocks, with values in the neighborhood of 2. But when conditioned on idiosyncratic shocks, the half-life of disaggregated real exchange rates falls dramatically, to a value about half of that for aggregate shocks.<sup>13</sup> The main lesson is that when conditioned on aggregate shocks, there is no longer a contrast in persistence between aggregate and

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<sup>12</sup> Half-lives are generated from simulated impulse responses. System (5) was simulated 1000 times using random draws of system parameters, where the mean and standard errors of the distribution are the average estimates among the goods. Half-lives are computed for aggregate and disaggregated data in each simulation, and the table reports the mean of these.

<sup>13</sup> No half-life is reported for the aggregate real exchange rate, since idiosyncratic shocks have essentially no effect on this variable.

disaggregated real exchange rates. Instead, the contrast is between aggregate and disaggregate shocks; disaggregated data responds slowly to the first and quickly to the latter. This indicates that once half-lives are conditioned on shocks, there appears to be no micro-macro disconnect puzzle. The finding in past work estimating half-lives that disaggregated real exchange rates adjust faster can be attributed to the dominance of a different composition of shocks for disaggregated data.

This basic lesson can be translated from terms of error corrections into the more familiar terms of autoregressions estimated in most past research. Consider the following aggregation exercise. Given that  $q_{ij,t}$  is the aggregation of  $q_{ij,t-1}^k$  over goods, it is viewed as a puzzle that estimates of their adjustment speeds are so different. Aggregating equation (2) over goods:

$$\begin{aligned} \frac{1}{K} \sum_{k=1}^K q_{ij,t}^k &= \frac{1}{K} \sum_{k=1}^K c_{ij}^k + \rho_{ij}^k q_{ij,t-1}^k + \varepsilon_{ij,t}^k \\ q_{ij,t} &= \frac{1}{K} \sum_{k=1}^K c_{ij}^k + \frac{1}{K} \sum_{k=1}^K \rho_{ij}^k q_{ij,t-1}^k + \frac{1}{K} \sum_{k=1}^K \varepsilon_{ij,t}^k \end{aligned} \quad (6)$$

Work by Imbs et al. (2005) has focused on the role of heterogeneity of adjustment speeds among the goods. If we allow for heterogeneity in the autoregressive coefficient  $\rho_{ij}^k$  among goods, equation (6)

differs from the aggregate equation (3) because  $\frac{1}{K} \sum_{k=1}^K \rho_{ij}^k q_{ij,t-1}^k \neq \rho_{ij} q_{ij,t-1}$ . If there is a correlation

between the variation in  $\rho_{ij}^k$  and  $q_{ij,t-1}^k$  among goods, so that slowly adjusting goods have larger price deviations, then this will bias upward estimates of the average speed of adjustment.

However, the vector error correction exercise demonstrated that the mechanism by which a good's price deviation is eliminated differs in response to the component of the price deviation that is common across goods and the component that is idiosyncratic to the particular good. If this distinction in adjustment mechanism affects the speed of adjustment, this suggests that the specification of the autoregression (2) should be expanded as follows to allow for this distinction:

$$q_{ij,t}^k = c_{qk,ij}^k + \rho_{qk,ij}^{k1} q_{ij,t-1}^k - q_{ij,t-1} + \rho_{qk,ij}^{k2} q_{ij,t-1} + \varepsilon_{qk,ij,t}^k \quad (7)$$

or equivalently

$$q_{ij,t}^k = c_{qk,ij}^k + \rho_{qk,ij}^{k1} q_{ij,t-1}^k + \rho_{qk,ij}^{k2} - \rho_{qk,ij}^{k1} q_{ij,t-1} + \varepsilon_{qk,ij,t}^k. \quad (7')$$

Here  $\rho_{qk,ij}^{k2}$  captures the adjustment in relative price of good  $k$  to aggregate macroeconomic price deviations, and  $\rho_{ij}^{k1}$  captures the response to price deviations that are specific to the good  $k$ . For completeness, an analogous expansion of the aggregate equation (3) can be defined (for each  $k$ ).

$$q_{ij,t} = c_{q,ij}^k + \rho_{q,ij}^{k1} q_{ij,t-1}^k - q_{ij,t-1} + \rho_{q,ij}^{k2} q_{ij,t-1} + \varepsilon_{q,ij,t}. \quad (8)$$

Now aggregate up equation (7):

$$\begin{aligned} \frac{1}{K} \sum_{k=1}^K q_{ij,t}^k &= \frac{1}{K} \sum_{k=1}^K c_{qk,ij}^k + \rho_{qk,ij}^{k1} q_{ij,t-1}^k - q_{ij,t-1} + \rho_{qk,ij}^{k2} q_{ij,t-1} + \varepsilon_{qk,ij,t}^k \\ q_{ij,t} &= \frac{1}{K} \sum_{k=1}^K c_{qk,ij}^k + \underbrace{\frac{1}{K} \sum_{k=1}^K \rho_{qk,ij}^{k1} q_{ij,t-1}^k - q_{ij,t-1}}_{\text{Term A}} + \underbrace{q_{ij,t-1} \frac{1}{K} \sum_{k=1}^K \rho_{qk,ij}^{k2}}_{\text{Term B}} + \frac{1}{K} \sum_{k=1}^K \varepsilon_{qk,ij,t}^k \end{aligned} \quad (9)$$

One observation is that, while heterogeneity in  $\rho_{qk,ij}^{k1}$  can lead to a heterogeneity bias in Term A in the same way as seen in equation (6), in contrast, heterogeneity in  $\rho_{qk,ij}^{k2}$  has no impact on aggregation of Term B, as the common component  $q_{ij,t-1}$  passes through the summation operator. So part of the heterogeneity among goods in terms of adjustment speed documented by Imbs et al. (2005) may be of an innocuous type, depending on how much applies to adjustment to aggregate  $q_{ij,t}$  deviations, and how much to good specific deviations to  $q_{ij,t}^k$ .

Table 8 shows the results of estimating equations (7) and (8). The first result is that the apparent inconsistency of the equations (2) and (3) has disappeared, when estimated in the augmented form of equations (7) and (8). If we focus on the response to aggregate deviations  $q_{ij,t-1}$ ,

the average response coefficients in the two equations are nearly the same. In the disaggregated equation the average coefficient is  $\frac{1}{K} \sum_{k=1}^K \rho_{qk,ij}^{k2} = 0.79$ , and in the aggregate equation the average coefficient is  $\frac{1}{K} \sum_{k=1}^K \rho_{q,ij}^{k2} = 0.80$ . So if one focuses just on responses to aggregate deviations, the aggregation puzzle disappears.

Further, Table 8 indicates the degree of heterogeneity in the coefficients in terms of the standard deviation of the estimates across goods. By this measure, the heterogeneity for the coefficient on the aggregated real exchange rate ( $q$ ) appears to be of similar magnitude to that for the idiosyncratic deviation ( $q_k - q$ ). Recall that it is only heterogeneity in the latter coefficient that fails to cancel out upon aggregation and thereby could lead to aggregation bias of the type described by Imbs et al.

Equation (7) also suggests that the estimations by Imbs et al. (2005) of an equation like (2) are subject to a potentially large omitted variable bias. Write equation (7) as

$$q_{ij,t}^k = c_{qk,ij}^k + \rho_{qk,ij}^{k1} q_{ij,t-1}^k + \rho_{qk,ij}^{k3} q_{ij,t-1}^k + \varepsilon_{qk,ij,t}^k \quad (10)$$

where  $\rho_{qk,ij}^{k3} \equiv \rho_{qk,ij}^{k2} - \rho_{qk,ij}^{k1}$

Estimating equation (2) ignores the second term. Generalizing the standard omitted variable bias formula to the case of our panel data, the bias would be:

$$E \left[ \rho^{k1} \right] = \rho^{k1} + \left( \sum_{ij=1}^N Q_{ij,-1}^{k'} M_w Q_{ij,-1}^k \right)^{-1} \left( \sum_{ij=1}^N Q_{ij,-1}^{k'} M_w \bar{Q}_{-1} \right) \tau + \left( \sum_{ij=1}^N Q_{ij,-1}^{k'} M_w Q_{ij,-1}^k \right)^{-1} \left( \sum_{ij=1}^N Q_{ij,-1}^{k'} M_w Q_{ij,-1} \right) \rho^{k3} \quad (11)$$

where

$$Q_{ij,-1}^k = (q_{ij,1}^k, q_{ij,2}^k, \dots, q_{ij,T-1}^k)'; \quad M_w = I - W(W'W)^{-1}W'; \quad W = (W_2', W_3', \dots, W_T)';$$

$$W_t = (1, \bar{q}_t^k, \bar{q}_{t-1}^k); \quad \bar{Q}_{-1} = (\bar{q}_2, \bar{q}_3, \dots, \bar{q}_T)'; \quad Q_{ij,-1} = (q_{ij,1}, q_{ij,2}, \dots, q_{ij,T-1})'.$$

and  $\tau$  is the coefficient of the cross-section mean in the augmented equation of (10) (see the appendix for the derivation).

Our findings also bring evidence to bear on the conjecture by Broda and Weinstein (2008) that lower persistence in disaggregated relative prices may be due to nonlinear adjustment. Previous work as demonstrated significant nonlinearities in aggregate real exchange rate adjustment, where convergence is faster for real exchange rate deviations that are large.<sup>14</sup> This may reflect the presence of costs of engaging in arbitrage, discouraging arbitrage responses to price deviations too small to generate sufficient profits to cover this cost. Broda and Weinstein (2008) suggest that if there is heterogeneity among goods in terms of the volatility of their price deviations, OLS estimates of convergence speed will place a heavy weight on the observations where the absolute value of deviations is large, thereby tending to find fast convergence. But as data is aggregated, they conjecture, large positive and negative price deviations are likely to cancel, so the weight given to small price deviations will increase, thereby tending to find slower convergence.

Our empirical work supports the idea, in a general sense, that faster convergence in disaggregated data is associated with greater volatility. When we compute the standard deviations of real exchange rate deviations at the goods level for each of the 98 goods in our data set, their average standard deviation is 4.8 times that of the aggregate real exchange rate (10.67% and 2.22% respectively). However, we do not find much heterogeneity among goods. For every one of our 98 goods, the standard deviation of price deviations exceeds that of the aggregate real exchange rate; the heterogeneity among goods is small compared to the gap between their average and the aggregate data. The same conclusion holds for convergence speeds: even though there is some variation in the convergence speeds among the goods in our sample when estimating equation (2), the price gap for every one of the 98 goods in our sample has a faster convergence speed than does the aggregate real exchange rate.

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<sup>14</sup> See Parsley and Wei (1996), Taylor et al. (2001), and Wu et al. (2009).

Instead of pointing to a distinction among goods, where certain goods with smaller volatility and slower convergence do not cancel out upon aggregation, our results instead point to distinct components of each good's price deviation, due to aggregate and idiosyncratic shocks, respectively, where the latter can reasonably be expected to have larger volatility and faster convergence, as well as to cancel out upon aggregation. This would seem to be a helpful way of reframing the role of nonlinearity conjectured in Broda and Weinstein (2008); the distinction between aggregate and idiosyncratic shocks makes this conjecture operational.

Finally, our findings have revealing implications for the use of sticky price models to describe real exchange rate behavior. Cheung et al. (2004) argued against sticky price models, emphasizing that the adjustment dynamics of the aggregate real exchange rate are dictated by the adjustment dynamics of the nominal exchange rate, not those of gradually adjusting sticky prices. On the one hand our result contrasts with this finding, showing that the adjustment in disaggregated real exchange rates is dictated by the dynamics of prices in the goods market. Nonetheless, our finding supports the overall conclusion of Cheung et al; it does not bolster the case for conventional sticky price models. Our result indicates that prices actually adjust quite quickly at the disaggregated level, indicating a limited degree of price stickiness.

#### **IV. Conclusions**

Past papers have been surprised that price deviations at the goods level adjust faster than do aggregate price deviations. This paper shows that differing speeds are just one part of a broader disparity in adjustment dynamics between aggregate and disaggregated prices. A vector error correction model indicates that while the nominal exchange rate does the adjusting at the aggregate level, it is the price that does the adjusting at the disaggregated level. The reason is that there are distinct shocks driving price deviations at these two levels of aggregation. The disaggregated level is

dominated by idiosyncratic shocks specific to the industry, which cancel out upon aggregation and have minimal impact upon aggregate dynamics.

This disconnect between the micro and macro levels of international price dispersion has implications for the literature. Firstly, we find evidence against the theory of aggregation bias offered by Imbs et al. (2005) as an explanation for the real exchange rate persistence. Longer persistence at the aggregate level appears to be due to distinct shocks at aggregate level, rather than heterogeneity in persistence at the disaggregated level.

Secondly, there are implications for the widespread use of sticky price models to explain real exchange rate behavior. We see evidence that there is rapid adjustment in prices to arbitrage opportunities at the microeconomic level, indicating a fair degree of price flexibility. However, these price movements selectively respond mainly to idiosyncratic shocks at the goods level, and appear to cancel out upon aggregation with minimal implications for aggregate variables like the aggregate real exchange rate. This finding does not coincide well with standard sticky price models of real exchange rate behavior. A model that coincides better with the evidence would be a sticky information story, where firms adjust to shocks specific to their industry rather than common macroeconomic shocks. Our empirical result suggests the usefulness of future theoretical work in this direction.

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## Appendix:

### Derivation of omitted variable bias:

Consider the following equation:

$$q_{ij,t}^k = c_{qk,ij}^k + \rho_{qk,ij}^{k1} q_{ij,t-1}^k + \rho_{qk,ij}^{k3} q_{ij,t-1}^k + \varepsilon_{qk,ij,t}^k, \quad (A1)$$

Omitting  $q_{ij,t-1}^k$  from (A1) and then augmenting the resulting equation with cross-section means:

$$q_{ij,t}^k = W_t \gamma'_{ij} + \rho_{qk,ij}^{k1} q_{ij,t-1}^k + v_{qk,ij,t}^k, \quad (A2)$$

where,  $W_t = (1, \bar{q}_t^k, \bar{q}_{t-1}^k)$  and  $\gamma_{ij} = (c_{qk,ij}^k, \delta_{ij}^1, \delta_{ij}^2)$ . The matrix representation of equation (A2) is:

$$Q_{ij}^k = W \gamma'_{ij} + Q_{ij,-1}^k \rho_{qk,ij}^{k1} + V_{ij}^k,$$

where,  $Q_{ij}^k = (q_{ij,2}^k, q_{ij,3}^k, \dots, q_{ij,T}^k)'$ ;  $W = (W_2', W_3', \dots, W_T)'$ ;  $Q_{ij,-1}^k = (q_{ij,1}^k, q_{ij,2}^k, \dots, q_{ij,T-1}^k)'$ ;

$V_{ij}^k = (v_{ij,2}^k, v_{ij,3}^k, \dots, v_{ij,T}^k)'$ ;

Based on equation (A1), the regression equation augmented with cross-section means is:

$$q_{ij,t}^k = R_t \kappa'_{ij} + \rho_{qk,ij}^{k1} q_{ij,t-1}^k + \rho_{qk,ij}^{k3} q_{ij,t-1}^k + \varepsilon_{qk,ij,t}^k,$$

where,  $R_t = (W_t, \bar{q}_{t-1}^k)$ ;  $\kappa_{ij} = (c_{qk,ij}^k, \delta_{ij}^1, \delta_{ij}^2, \tau_{ij}) = (\gamma_{ij}, \tau_{ij})$ . The matrix representation of the above

equation is :

$$Q_{ij}^k = R \kappa'_{ij} + Q_{ij,-1}^k \rho_{qk,ij}^{k1} + Q_{ij,-1}^k \rho_{qk,ij}^{k3} + \xi_{ij}^k. \quad (A3)$$

where,  $R = (R_2', R_3', \dots, R_T)'$ ;  $Q_{ij,-1}^k = (q_{ij,1}^k, q_{ij,2}^k, \dots, q_{ij,T-1}^k)'$ ;  $\xi_{ij}^k = (\varepsilon_{ij,2}^k, \varepsilon_{ij,3}^k, \dots, \varepsilon_{ij,T}^k)'$ .

Plugging equation (A3) into the pooling estimates of  $\hat{\rho}^{k1}$  from equation (A2), one can derive the following equation with some simple manipulation.

$$\begin{aligned} \hat{\rho}^{k1} = & \left( \sum_{ij=1}^N Q_{ij,-1}^{k'} M_w Q_{ij,-1}^k \right)^{-1} \sum_{ij=1}^N Q_{ij,-1}^{k'} M_w \bar{Q}_{-1} \tau + \left( \sum_{ij=1}^N Q_{ij,-1}^{k'} M_w Q_{ij,-1}^k \right)^{-1} \left( \sum_{ij=1}^N Q_{ij,-1}^{k'} M_w Q_{ij,-1}^k \rho^{k3} \right) \\ & + \left( \sum_{ij=1}^N Q_{ij,-1}^{k'} M_w Q_{ij,-1}^k \right)^{-1} \left( \sum_{ij=1}^N Q_{ij,-1}^{k'} M_w \xi_{ij}^k \right) + \rho^{k1} \end{aligned}$$

where,  $M_w = I - W(W'W)^{-1}W'$ ;  $\bar{Q}_{-1} = (\bar{q}_2, \bar{q}_3, \dots, \bar{q}_T)'$ .

$$\begin{aligned} E\left[\rho^{k1}\right] &= \rho^{k1} + \left(\sum_{ij=1}^N Q_{ij,-1}^{k'} M_w Q_{ij,-1}^k\right)^{-1} \left(\sum_{ij=1}^N Q_{ij,-1}^{k'} M_w \bar{Q}_{-1}\right) \tau + \left(\sum_{ij=1}^N Q_{ij,-1}^{k'} M_w Q_{ij,-1}^k\right)^{-1} \left(\sum_{ij=1}^N Q_{ij,-1}^{k'} M_w Q_{ij,-1}\right) \rho^{k3} \\ &= \rho^{k1} + \mathbf{Bias} \end{aligned}$$

Table 1: Stationarity of relative prices

Sample	(mean)	(mean)	significance		
	$b$	t-stat	1%	5%	10%
<u>Disaggregated data:</u>					
Traded: (out of 98)	-0.316	-2.434	47	63	72
Nontraded (out of 30)	-0.242	-2.121	8	11	11
<u>Aggregated data:</u>					
Traded:	-0.284	-2.447	Yes	Yes	Yes
Non-traded	-0.220	-1.868	No	No	No

For disaggregated data, table reports  $b$  and t-stat means over the goods, and significance reports the number of goods that reject nonstationarity at the specified significance level.

Table 2. Half-lives in autoregressions of real exchange rates

Sample	(Mean) $\rho_1$	(Mean) t-stat	(Mean) $\rho_2$	(Mean) t-stat	(Mean) Half-life <sup>1</sup>
<u>AR(2):</u>					
Disaggregated data	0.715	10.620	0.050	0.696	1.25
Aggregated data	0.896	13.879	-0.054	-1.195	2.10
<u>AR(1):</u>					
Disaggregated data	0.739	14.250			1.15
Aggregated data	0.850	20.399			2.13

<sup>1</sup>Half-life in years, based upon simulated impulse responses.  
For disaggregated data, values reported are means across goods.

Table 3: Vector error correction estimates

	<u>(mean)</u> <u><math>\rho</math></u>	<u>(mean)</u> <u>t-stat</u>	<u>Heterogeneity</u> <u>(Std.Dev.)<sup>1</sup></u>	<u>Significance</u>		
				<u>1%</u>	<u>5%</u>	<u>10%</u>
<u>Disaggregated Data (for 98 traded goods):</u>						
Exchange rate equation	-0.028	-2.260	0.015	35	54	69
Price ratio equation	-0.203	-4.074	0.087	75	87	92
<u>Aggregated Data:</u>						
Exchange rate equation	-0.126	-3.520		yes	yes	yes
Price ratio equation	-0.044	-3.377		yes	yes	yes

<sup>1</sup>Standard deviation of  $\rho$  estimates across goods, reported as a measure of heterogeneity among goods.

For disaggregated data, values reported are means across goods, and significance reports the number of goods with coefficients significantly different from zero at the specified significance level.

Table 4: Vector error correction estimates using data set from Imbs et al. (2005)

	<u>(mean)</u> <u><math>\rho</math></u>	<u>(mean)</u> <u>t-stat</u>
<u>Disaggregated Data:</u>		
Exchange rate equation	-0.016	-2.540
Price ratio equation	-0.036	-3.606
<u>Aggregated Data:</u>		
Exchange rate equation	-0.025	-2.836
Price ratio equation	-0.016	-2.771

Source: III\_CCEP\_ImbsData

Table 5: 3-Equation vector error correction estimates

	Response to $q_k-q$			Response to $q$		
	Mean $\rho$	Mean t-stat	Hetero- geneity: StdDev <sup>1</sup>	Mean $\rho$	Mean t-stat	Hetero- geneity: StdDev <sup>1</sup>
Exchange rate equation	-0.002	-0.095	0.017	-0.163	-3.688	0.035
Aggregated Price equation	0.001	0.006	0.011	-0.055	-2.614	0.012
Disaggregated Price equation	-0.301	-3.612	0.117	-0.065	-0.543	0.106

<sup>1</sup>Standard deviation of parameter estimates across goods.

Table 6: Relative contributions of nominal exchange rate and price adjustments to PPP and LOP Reversion

		under an exchange rate shock		under an aggregate price shock		under a disaggregate price shock	
disaggregated	years	$g_{e,e}^{qk}$	$g_{pk,e}^{qk}$	$g_{e,p}^{qk}$	$g_{pk,p}^{qk}$	$g_{e,pk}^{qk}$	$g_{pk,pk}^{qk}$
$q_k$ :	1	0.73	0.27	0.64	0.36	0.01	0.99
	2	0.78	0.22	0.71	0.29	0.01	0.99
	3	0.80	0.20	0.73	0.27	0.00	1.00
	5	0.84	0.16	0.78	0.22	-0.02	1.02
	10	0.93	0.07	0.88	0.12	-0.08	1.08
aggregate $q$ :	years	$g_{e,e}^q$	$g_{p,e}^q$	$g_{e,p}^q$	$g_{p,p}^q$	$g_{e,pk}^q$	$g_{p,pk}^q$
	1	0.77	0.23	0.76	0.24	0.98	0.02
	2	0.79	0.21	0.79	0.21	1.32	-0.32
	3	0.79	0.21	0.79	0.21	-0.85	1.85
	5	0.79	0.21	0.79	0.21	0.63	0.37
	10	1.79	0.21	0.79	0.21	0.75	0.25

The columns  $g_{i,j}^{qk}$  indicates the proportion of adjustment in the relative price  $q_k$  explained by adjustment in variable i, conditional on shock j. The columns  $g_{i,j}^q$  indicate the same proportion for adjustment in the aggregated real exchange rate  $q$ .

Table 7. Estimates half-lives conditional on shock

	$e$ shock	$p$ shock	$p_k$ shock
Disaggregated $q_k$	1.96	1.91	1.09
Aggregated $q$	1.63	1.83	---

Half-lives in years, estimated from impulse responses of equation system (5).

Table 8. Estimates of speeds of adjustment in expanded autoregression

	Response to $q_k - q$			Response to $q$		
	Mean $\rho$	Mean t-stat	Hetero- geneity: StdDev <sup>1</sup>	Mean $\rho$	Mean t-stat	Hetero- geneity: StdDev <sup>1</sup>
Disaggregated data	0.678	9.552	0.131	0.787	7.198	0.111
Aggregated data	-0.001	-1.040	0.018	0.803	16.860	0.039

<sup>1</sup>Standard deviation of parameter estimates across goods.

Fig. 1 Variance Decomposition of  $q_k$

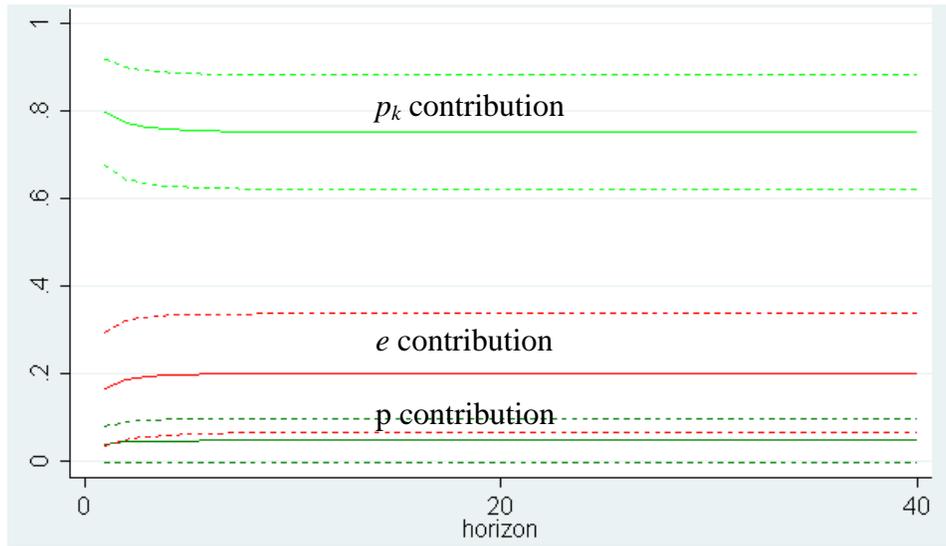


Fig. 2 Variance Decomposition of  $q$

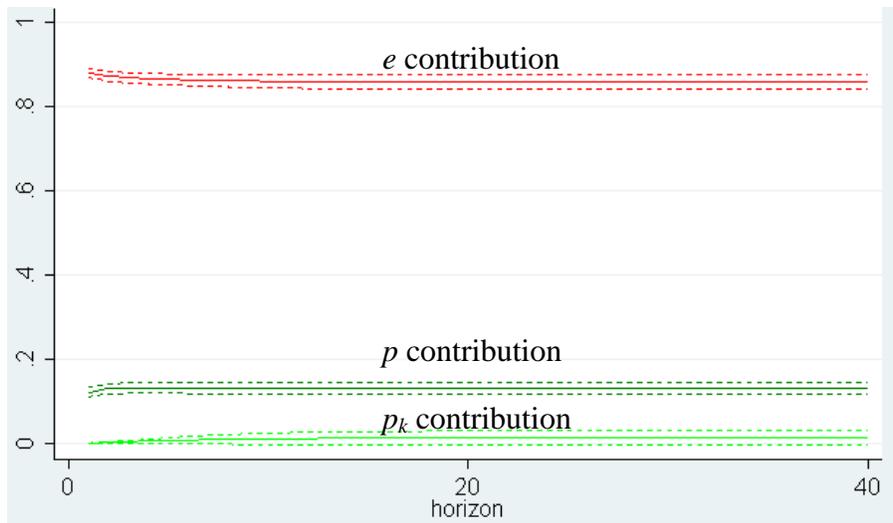


Fig. 3. Impulse response to  $p_k$  shock

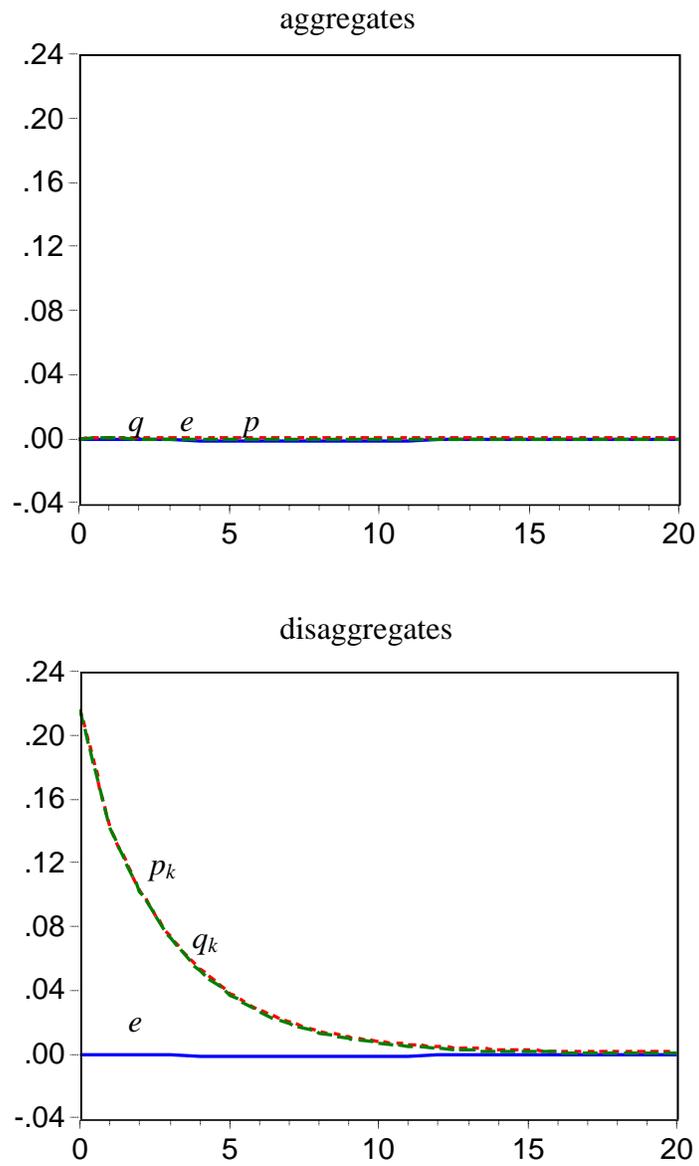
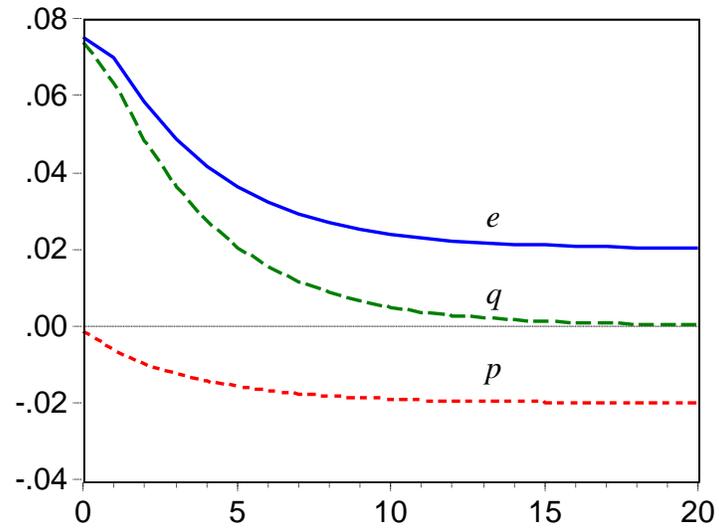


Fig. 4. Impulse response to  $e$  shock

aggregates



disaggregates

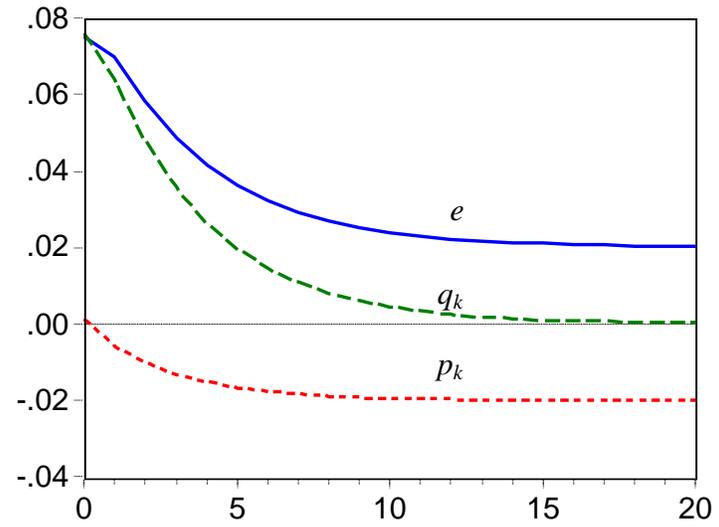


Fig. 5. Impulse response to  $p_k$  shock

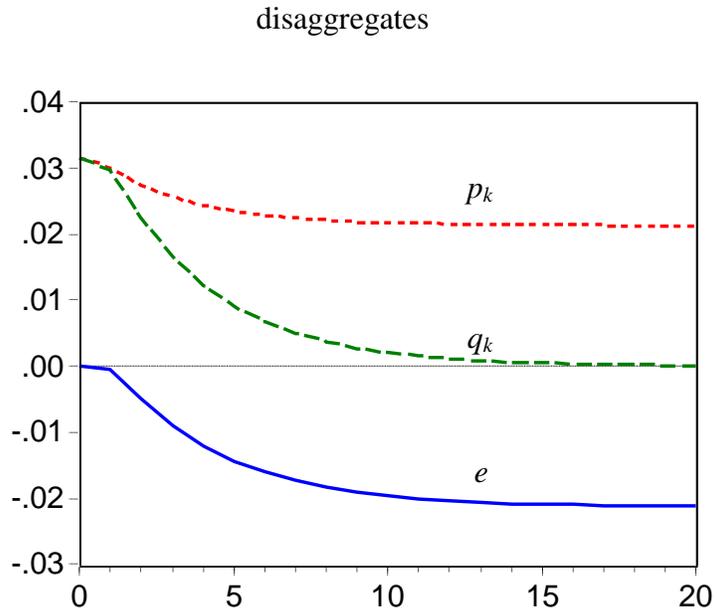
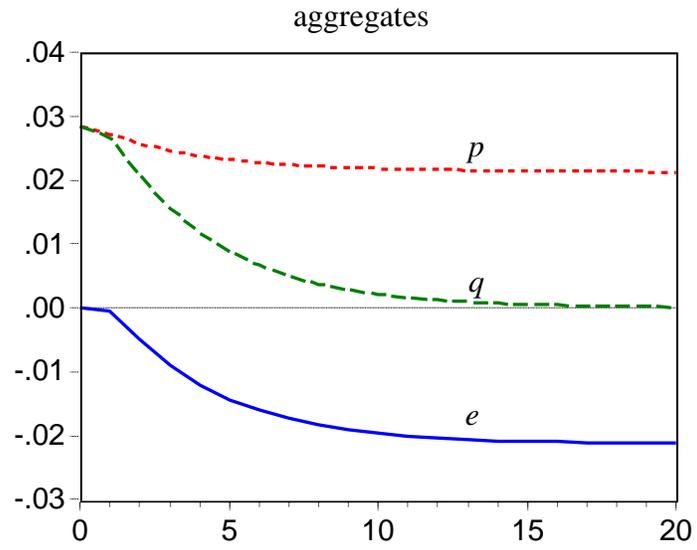


Table A1. Cities in sample of 20 Industrial Countries and U.S.

<u>city</u>	<u>country</u>
Amsterdam	Netherlands
Athens	Greece
Auckland	New Zealand
Berlin	Germany
Brussels	Belgium
Copenhagen	Denmark
Helsinki	Finland
Lisbon	Portugal
London	United Kingdom
Luxembourg	Luxembourg
Madrid	Spain
Oslo	Norway
Paris	France
Rome	Italy
Stockholm	Sweden
Sydney	Australia
Tokyo	Japan
Toronto	Canada
Vienna	Austria
Zurich	Switzerland
New York	United States

Table A2. Traded Items in Sample, by Category

<i>Food and non-alcoholic beverages: perishable</i>	<i>Food and non-alcoholic beverages: Non-perishable</i>	<i>Alcoholic beverages</i>
White bread (1 kg)	White rice (1 kg)	Wine, common table (750 ml)
Butter (500 g)	Olive oil (1 l)	Wine, superior quality (750 ml)
Margarine (500 g)	Peanut or corn oil (1 l)	Wine, fine quality (750 ml)
Spaghetti (1 kg)	Peas, canned (250 g)	Beer, local brand (1 l)
Flour, white (1 kg)	Tomatoes, canned (250 g)	Beer, top quality (330 ml)
Sugar, white (1 kg)	Peaches, canned (500 g)	Scotch whisky, six yrs old (700 ml)
Cheese, imported (500 g)	Sliced pineapples, can (500 g)	Gin, Gilbey's or equivalent (700 ml)
Cornflakes (375 g)	Chicken: frozen (1 kg)	Vermouth, Martini & Rossi (1 l)
Milk, pasteurised (1 l)	Frozen fish fingers (1 kg)	Cognac, French VSOP (700 ml)
Potatoes (2 kg)	Instant coffee (125 g)	Liqueur, Cointreau (700 ml)
Onions (1 kg)	Ground coffee (500 g)	
Tomatoes (1 kg)	Tea bags (25 bags)	<i>Recreation</i>
Carrots (1 kg)	Cocoa (250 g)	Compact disc album
Oranges (1 kg)	Drinking chocolate (500 g)	Television, colour (66 cm)
Apples (1 kg)	Coca-Cola (1 l)	Kodak colour film (36 exposures)
Lemons (1 kg)	Tonic water (200 ml)	Intl. weekly news magazine (Time)
Bananas (1 kg)	Mineral water (1 l)	Internat. foreign daily newspaper
Lettuce (one)		Paperback novel (at bookstore)
Eggs (12)		
Beef: filet mignon (1 kg)	<i>Clothing and footwear</i>	<i>Personal care</i>
Beef: steak, entrecote (1 kg)	Business suit, two piece, med. wt.	Aspirins (100 tablets)
Beef: stewing, shoulder (1 kg)	Business shirt, white	Razor blades (five pieces)
Beef: roast (1 kg)	Men's shoes, business wear	Toothpaste with fluoride (120 g)
Beef: ground or minced (1 kg)	Mens raincoat, Burberry type	Facial tissues (box of 100)
Veal: chops (1 kg)	Socks, wool mixture	Hand lotion (125 ml)
Veal: fillet (1 kg)	Dress, ready to wear, daytime	Lipstick (deluxe type)
Veal: roast (1 kg)	Women's shoes, town	
Lamb: leg (1 kg)	Women's cardigan sweater	<i>Household supplies</i>
Lamb: chops (1 kg)	Women's raincoat, Burberry type	Toilet tissue (two rolls)
Lamb: stewing (1 kg)	Tights, panty hose	Soap (100 g)
Pork: chops (1 kg)	Child's jeans	Laundry detergent (3 l)
Pork: loin (1 kg)	Child's shoes, dresswear	Dishwashing liquid (750 ml)
Ham: whole (1 kg)	Child's shoes, sportswear	Insect-killer spray (330 g)
Bacon (1 kg)	Girl's dress	Light bulbs (two, 60 watts)
Chicken: fresh (1 kg)	Boy's jacket, smart	Frying pan (Teflon or equivalent)
Fresh fish (1 kg)	Boy's dress trousers	Electric toaster (for two slices)
Orange juice (1 l)		Batteries (two, size D/LR20)

Table A3. Non-traded items

Laundry (one shirt)	Domestic cleaning help	Regular unleaded petrol
Dry cleaning, man's suit	Maid's monthly wages	Taxi: initial meter charge
Dry cleaning, woman's dress	Babysitter	Taxi rate per additional kilometre
Dry cleaning, trousers	Developing 36 colour pictures	Taxi: airport to city centre
Man's haircut	Daily local newspaper	Two-course meal for two people
Woman's cut & blow dry	Three-course dinner	Hire car
Telephone and line	Seats at theatre or concert	
Electricity	Seats at cinema	
Gas Tune-up	Road tax or registration fee	
Water	Moderate hotel, single room	
Business trip, daily cost	One drink at bar of hotel	
Hilton-type hotel, single room	Simple meal for one person	

Table A4: Error Correction results detailed by bood

Product Description	e-coef	t-stat	p-coef	tstat
Instant coffee (125 g) (supermarket)	-0.040	-2.779	-0.186	-3.799
Coca-Cola (1 l) (supermarket)	-0.044	-3.520	-0.183	-2.376
Tonic water (200 ml) (supermarket)	-0.031	-2.657	-0.144	-3.249
Mineral water (1 l) (supermarket)	-0.037	-4.252	-0.179	-5.701
Orange juice (1 l) (supermarket)	-0.020	-1.151	-0.169	-1.417
Ground coffee (500 g) (supermarket)	-0.020	-1.671	-0.183	-4.995
Tea bags (25 bags) (supermarket)	-0.034	-4.603	-0.170	-4.755
Cocoa (250 g) (supermarket)	-0.023	-1.339	-0.163	-4.869
Drinking chocolate (500 g) (supermarket)	-0.056	-3.394	-0.204	-5.699
Peas, canned (250 g) (supermarket)	-0.025	-2.861	-0.228	-5.175
Tomatoes, canned (250 g) (supermarket)	-0.024	-2.162	-0.117	-2.396
Peaches, canned (500 g) (supermarket)	-0.021	-1.422	-0.138	-1.041
Sliced pineapples, canned (500 g) (supermarket)	-0.017	-1.626	-0.205	-2.448
Potatoes (2 kg) (supermarket)	-0.009	-1.704	-0.444	-7.576
Oranges (1 kg) (supermarket)	-0.015	-3.529	-0.333	-2.421
Apples (1 kg) (supermarket)	0.001	0.131	-0.339	-4.770
Lemons (1 kg) (supermarket)	-0.018	-4.107	-0.249	-4.189
Bananas (1 kg) (supermarket)	-0.020	-2.185	-0.535	-7.828
Lettuce (one) (supermarket)	-0.035	-4.420	-0.373	-9.018
Eggs (12) (supermarket)	-0.015	-1.128	-0.257	-5.424
Onions (1 kg) (supermarket)	-0.022	-2.335	-0.471	-6.222
Tomatoes (1 kg) (supermarket)	-0.017	-2.763	-0.379	-3.665
Carrots (1 kg) (supermarket)	-0.010	-2.115	-0.457	-7.153
Beef: filet mignon (1 kg) (supermarket)	-0.014	-1.142	-0.208	-8.700
Veal: chops (1 kg) (supermarket)				
Veal: fillet (1 kg) (supermarket)	-0.017	-0.531	-0.255	-5.083
Veal: roast (1 kg) (supermarket)				
Lamb: leg (1 kg) (supermarket)	-0.011	-1.060	-0.196	-3.273
Lamb: chops (1 kg) (supermarket)	-0.036	-3.273	-0.290	-6.405
Lamb: stewing (1 kg) (supermarket)	-0.001	-0.238	-0.190	-2.115
Pork: chops (1 kg) (supermarket)	-0.040	-4.236	-0.198	-3.149
Pork: loin (1 kg) (supermarket)	-0.033	-4.955	-0.256	-4.581
Ham: whole (1 kg) (supermarket)	-0.018	-1.214	-0.214	-2.596
Bacon (1 kg) (supermarket)	-0.016	-1.649	-0.164	-3.255
Beef: steak, entrecote (1 kg) (supermarket)	-0.037	-1.996	-0.176	-2.396
Chicken: frozen (1 kg) (supermarket)				
Chicken: fresh (1 kg) (supermarket)	-0.038	-3.920	-0.237	-4.833
Frozen fish fingers (1 kg) (supermarket)	-0.010	-1.297	-0.317	-4.374
Fresh fish (1 kg) (supermarket)	-0.009	-0.795	-0.135	-4.528
Beef: stewing, shoulder (1 kg) (supermarket)	-0.028	-3.092	-0.297	-4.657
Beef: roast (1 kg) (supermarket)	-0.021	-2.197	-0.213	-3.500
Beef: ground or minced (1 kg) (supermarket)	-0.025	-1.973	-0.224	-4.567
White bread, 1 kg (supermarket)	-0.023	-1.884	-0.114	-3.050
Flour, white (1 kg) (supermarket)	-0.035	-2.292	-0.125	-2.533
Sugar, white (1 kg) (supermarket)	-0.069	-2.698	-0.305	-7.383
Cheese, imported (500 g) (supermarket)	-0.026	-2.459	-0.249	-5.500

Cornflakes (375 g) (supermarket)	-0.025	-2.054	-0.269	-3.390
Milk, pasteurised (1 l) (supermarket)	-0.054	-3.187	-0.183	-4.141
Olive oil (1 l) (supermarket)	-0.017	-1.211	-0.272	-4.571
Peanut or corn oil (1 l) (supermarket)	-0.023	-2.999	-0.070	-1.757
Butter, 500 g (supermarket)	-0.031	-1.728	-0.192	-3.022
Margarine, 500 g (supermarket)	-0.050	-4.268	-0.229	-3.622
White rice, 1 kg (supermarket)	-0.018	-1.854	-0.206	-3.101
Spaghetti (1 kg) (supermarket)	-0.031	-3.122	-0.254	-4.769
Wine, common table (1 l) (supermarket)	-0.027	-1.653	-0.160	-1.770
Scotch whisky, six years old (700 ml) (supermarket)	-0.055	-2.859	-0.179	-4.692
Gin, Gilbey's or equivalent (700 ml) (supermarket)	-0.040	-1.743	-0.096	-1.825
Vermouth, Martini & Rossi (1 l) (supermarket)	-0.028	-2.461	-0.096	-0.892
Cognac, French VSOP (700 ml) (supermarket)	-0.012	-0.583	-0.188	-4.332
Liqueur, Cointreau (700 ml) (supermarket)	-0.052	-1.915	-0.154	-5.943
Wine, superior quality (700 ml) (supermarket)	-0.021	-1.826	-0.179	-2.856
Wine, fine quality (700 ml) (supermarket)	-0.009	-0.497	-0.186	-3.406
Beer, local brand (1 l) (supermarket)	-0.039	-2.189	-0.126	-2.514
Beer, top quality (330 ml) (supermarket)	-0.038	-3.279	-0.237	-5.950
Soap (100 g) (supermarket)	-0.006	-0.506	-0.129	-4.614
Light bulbs (two, 60 watts) (supermarket)	-0.018	-1.040	-0.228	-5.955
Batteries (two, size D/LR20) (supermarket)	-0.026	-2.007	-0.170	-2.952
Frying pan (Teflon or good equivalent) (supermarket)	-0.053	-5.538	-0.242	-6.340
Electric toaster (for two slices) (supermarket)	-0.027	-1.076	-0.133	-4.644
Laundry detergent (3 l) (supermarket)	-0.016	-3.146	-0.137	-4.626
Toilet tissue (two rolls) (supermarket)	-0.034	-1.506	-0.283	-5.036
Dishwashing liquid (750 ml) (supermarket)	-0.025	-1.445	-0.136	-3.014
Insect-killer spray (330 g) (supermarket)	-0.029	-2.452	-0.219	-5.818
Aspirins (100 tablets) (supermarket)	-0.022	-1.958	-0.150	-3.605
Lipstick (deluxe type) (supermarket)	-0.019	-0.860	-0.108	-2.281
Razor blades (five pieces) (supermarket)	-0.022	-3.112	-0.067	-1.125
Toothpaste with fluoride (120 g) (supermarket)	-0.047	-3.687	-0.199	-4.768
Facial tissues (box of 100) (supermarket)	-0.009	-0.757	-0.171	-6.593
Hand lotion (125 ml) (supermarket)	-0.025	-3.502	-0.154	-3.216
Child's jeans (chain store)	-0.021	-1.928	-0.137	-2.101
Boy's dress trousers (chain store)	-0.031	-1.810	-0.201	-3.214
Child's shoes, dresswear (chain store)	-0.044	-2.681	-0.153	-4.611
Child's shoes, sportswear (chain store)	-0.011	-0.913	-0.186	-6.483
Girl's dress (chain store)	-0.018	-1.785	-0.222	-3.660
Boy's jacket, smart (chain store)	-0.027	-3.380	-0.224	-5.385
Business suit, two piece, medium weight (chain store)	-0.024	-2.776	-0.060	-1.856
Business shirt, white (chain store)	-0.023	-2.336	-0.221	-2.951
Men's shoes, business wear (chain store)	-0.029	-2.679	-0.204	-3.372
Men's raincoat, Burberry type (chain store)	-0.018	-2.974	-0.158	-2.502
Socks, wool mixture (chain store)	-0.024	-1.996	-0.165	-2.639
Dress, ready to wear, daytime (chain store)	-0.019	-1.404	-0.054	-0.855
Women's shoes, town (chain store)	-0.048	-4.697	-0.152	-5.585

Women's cardigan sweater (chain store)	-0.029	-2.399	-0.301	-7.125
Women's raincoat, Burberry type (chain store)	-0.018	-1.885	-0.197	-4.698
Tights, panty hose (chain store)	-0.016	-1.030	-0.163	-4.493
Compact disc album (average)	-0.077	-2.059	-0.130	-5.062
Television, colour (66 cm) (average)	-0.024	-1.392	-0.102	-1.903
International foreign daily newspaper (average)	-0.055	-3.085	-0.141	-3.789
International weekly news magazine (Time) (average)	-0.056	-1.948	-0.240	-2.022
Paperback novel (at bookstore) (average)	-0.028	-1.473	-0.084	-1.197
Kodak colour film (36 exposures) (average)	-0.056	-2.341	-0.158	-3.911
<hr/>				
Averages: Mean	-0.028	-2.260	-0.203	-4.074
Averages: Median	-0.024	-2.057	-0.187	-4.026
<hr/>				