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Purchasing power parity and the behavior of prices and nominal exchange rates across exchange-rate regimes

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Highlights:

- Investigate the relation linking exchange rates and price levels in different monetary regimes.
- Use annual multi-country panel data for 1870 -1914, 1921-39 and 1959-1998.
- Price levels in the different regimes behave the way theory suggests.
- Adjusted for exchange rate changes, inflation rates are related one-to-one.
- As long-run proposition purchasing power parity performs very well.

Abstract: The evidence presented in this paper shows that purchasing power parity as a long-run proposition is indeed a very useful approximation. We see this quite clearly in the panel data for three historical periods examined here – the classical gold standard era from 1870 to 1914, the interwar period from 1921 to 1939, and the period after World War II from 1959 to 1998. Price-level behavior across countries differs in the way that PPP suggests when monetary arrangements differ and is highly similar when monetary arrangements are themselves similar. Inflation rates adjusted for exchange rate changes in general are highly correlated and bear a one-to-one relation to one another within and across the three periods and the varied monetary regimes that prevailed.

JEL Classification: F31, F33, F41

Keywords: Exchange rates, purchasing power parity, international transmission, monetary regimes.

1. Introduction

Let me first of all thank my friend and colleague Iftekhar Hasan for organizing this conference at which I presented this paper and for editing this special issue of *JIMF* – a journal with which I was affiliated for two-thirds of my 50-year career. Let me also thank Kees Koedijk, *JIMF* 's Co-ordinating Editor and a long-time friend for his