

Real Exchange Rate Determination and Generalized Purchasing Power Parity: New Zealand and Australia

Minsoo Lee
Economics Department
Commerce Division
Lincoln University
Canterbury, New Zealand

Sung K. Ahn
Department of Management and Decision Sciences
Washington State University
Pullman, WA 99164-4736

Abstract

Many empirical studies on exchange rates determination suggest the following facts: real shocks can induce changes in real exchange rates, permanent real shocks can produce permanent movements in real exchange rates implying a deviation from Purchasing Power Parity (PPP), and given the long-run neutrality of money, nominal shocks have only temporary effects. The bilateral real exchange rate series for Australia (AUS) and New Zealand (NZ) are non-stationary as implied by an empirical failure of PPP. We present a model for the real exchange rate series of NZ and AUS. The fundamental variables in the model include terms of trade, productivity bias, import tariffs, and real interest differentials. We also examine the effects on the real exchange rates of the following variables; differences and similarities in composition of trade, trade by destination and internal variables such as the trade deficit ratios and budget deficit ratios. Although bilateral real exchange rates are non-stationary, they will share the common stochastic trend if the economies are highly interrelated to each other implying Generalized PPP occurs. Given the high degree of interrelationship between NZ and AUS through trade agreements such as New Zealand Australia Free Trade Agreement (NAFTA) and Australia New Zealand Closer Economic Relations Trade Agreement (ANZCERTA) and linked capital and labour market, we show the existence of the long run relation between the two bilateral real exchange rates using the error correction representation of the structural vector autoregressive model.