

Beyond Balassa - Samuelson: Real Appreciation in Tradables in Transition Countries

Non-technical summary

Martin Cincibuch and Jiří Podpiera

Being affected by all border, substitution and measurement factors, the real exchange rate is too approximate to have a great relevance as a measure of the relative price of the home and foreign goods. It is confirmed by the empirical literature suggesting that although the deviations from purchasing power parity for tradable goods tend to die out, the convergence is extremely slow. Taking intuition of the large PPP, pass-through and pricing to market literature, we propose an extremely simple, arbitrage based model, that leads to the decomposition of the real exchange rate between substitution and pricing to market component, the real exchange rate disparity.

We document that almost by a rule the relative prices of the goods produced by the transition economy and sold on the either market segment drifted upwards. Most likely, it is attributable the quality adjustment bias. It remain to be seen whether such a process may continue. Indeed, the continued integration of the manufacturing production into the globalised economy will lead to the saturation of the process. This is a major source of the trend real exchange appreciation in tradables. Yet, this structural appreciation is slower then the overall real exchange rate appreciation. Depending on the size of the no-arbitrage band, the pricing to market component absorbs the rest of the process. Indeed, the pricing to market component exhibits no trend but adds to medium term volatility of the exchange rate.

On the example of the disaggregated data of manufactured products from CE transition economies and Germany we show that the disparity fluctuate less for more homogenous and arbitrage friendly goods and that there is a potential for large deviations from the law of one price for differentiated products like cars. Perhaps, because the differentiation allows producers to elevate more barriers to cross-border trade.

An additional theoretical structure imposed on the data is useful in several respects. First, it allows form testable hypotheses that regard exchange pass-through. Empirical tests may validate underlying structure. Then it might be useful for inflation forecasts. Second, it might be helpful in judgement about cyclical position of the particular economy. It stems from the fact that components extracted from the decomposition have naturally different trending and cyclical behaviour. Thus, there is open way for enhancing filtering methods for estimating various economy gaps in monetary policy models.