

# Size distortions of tests of the null hypothesis of stationarity: evidence and implications for the PPP debate

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## Abstract

Tests of the null hypothesis of stationarity against the unit root alternative play an increasingly important role in empirical work in macroeconomics and in international finance. We show that the use of conventional asymptotic critical values for stationarity tests may cause extreme size distortions, if the model under the null hypothesis is highly persistent. This fact calls into question the use of these tests in empirical work. We illustrate the practical importance of this point for tests of long-run purchasing power parity (PPP) under the recent float. We show that the common practice of viewing tests of stationarity as complementary to tests of the unit root null will tend to result in contradictions and in spurious rejections of long-run PPP. While the size distortions may be overcome by the use of finite-sample critical values, the resulting tests tend to have low power under economically plausible assumptions about the half-life of deviations from PPP. Thus, the fact that stationarity is not rejected cannot be interpreted as convincing evidence in favor of mean reversion. Only in the rare case that stationarity is rejected, do size-corrected tests shed light on the question of long-run PPP. © 2001 Elsevier Science Ltd. All rights reserved.

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## 1. Introduction

Recently, there has been increasing interest in tests of the null hypothesis of a level stationary process (or more precisely  $I(0)$  process) against the alternative of a difference stationary (or  $I(1)$ ) process. These tests are widely used in empirical macroeconomics and in international finance both in their own right and as complements to more traditional tests of the unit root null hypothesis (Lewbel, 1996; Culver and Papell 1997, 1999; Lee et al., 1997; Collins and Anderson, 1998; Wolters et al., 1998; Kuo and Mikkola, 1999).<sup>1</sup> We show that there are serious problems with the interpretation of these tests in practice that applied users need to be aware of and that are of immediate relevance for many questions in international finance, including tests of long-run purchasing power parity (PPP).

The two most widely used tests of the  $I(0)$  null hypothesis are due to Kwiatkowski et al. (1992), henceforth KPSS test, and to Leybourne and McCabe (1994), henceforth LMC test. Asymptotic critical values for both tests are given in Kwiatkowski et al. (1992). However, these critical values make no distinction between a process that is white noise and a highly persistent stationary process. We provide new evidence that in models with roots close to unity the use of asymptotic critical values may cause extreme size distortions. The existence of such size distortions has not been documented in the previous literature. While Kwiatkowski et al. (1992) report some size results for the KPSS test, their data generating processes are of relevance mainly for annual data. Leybourne and McCabe (1994) report low size distortions for the Leybourne and McCabe test in a somewhat more realistic setting, but their favorable simulation results appear to be due to a programming error. In contrast, we provide a comprehensive analysis of the size of both the KPSS test and the LMC test for the regions in the parameter space that are relevant for typical quarterly and monthly processes.

Our findings of severe size distortions are of immediate practical interest. It is well known that the processes of interest in empirical macroeconomics and in international finance tend to be highly persistent even under the null of stationarity (Rudebusch, 1993; Diebold and Senhadji, 1996; Lothian and Taylor, 1996). Since for such processes the KPSS and LMC test have a tendency to reject the null of stationarity whether it is true or not, we conclude that it is all but impossible to interpret rejections of the stationarity hypothesis in empirical work.

This fact also has important implications for the common practice of testing both the null hypothesis of a unit root and that of stationarity. Evidence against the stationarity null, but not the unit root null is typically interpreted as conclusive evidence that the underlying process is difference stationary (Baillie and Pecchenino, 1991; Cheung and Chinn, 1997; Ely and Robinson, 1997; Moreno, 1997). Our results imply that applied users will tend to accept spuriously the difference stationary model in

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<sup>1</sup> Stationarity tests also have been modified for the purpose of testing the null of cointegration (see Harris and Inder, 1994; Shin, 1994; McCabe et al., 1997). In related work, Caner (1998) discusses applications of stationarity tests at seasonal frequencies.

practice, given the low power of unit root tests. Rejections of stationarity in favor of a unit root process are indeed common in applied work. Moreover, size distortions of stationarity tests may generate contradictory test results with both null hypotheses being rejected.

We illustrate the practical importance of this point for tests of long-run PPP in the post-Bretton Woods period. Our empirical analysis extends recent work by Culver and Papell (1999) who applied the KPSS test to quarterly data under the recent float. We use both the KPSS and the LMC test, and we include monthly real exchange rate data in our analysis. We find that both tests are likely to overstate the evidence against long-run PPP under the recent float. Notably the LMC test rejects the null of stationarity for virtually all countries in favor of a unit root process.

An important question is to what extent the size distortions of stationarity tests may be mitigated by replacing the asymptotic critical values by size-adjusted finite-sample critical values. Recently, such corrections have been employed by Cheung and Chinn (1997), Rothman (1997) and Kuo and Mikkola (1999), among others. We derive size-corrected critical values for the LMC and KPSS test under economically plausible assumptions about the half-life of deviations from PPP. Using size-adjusted critical values for the KPSS and LMC test instead of asymptotic critical values, we are unable to reject the stationarity null for any country but Japan.

However, this sharp reversal in results cannot be interpreted as convincing evidence in favor of long-run PPP. We show that after size corrections the power of the KPSS (LMC) test may fall as low as 20% (22%) at the 5% level for the sample sizes and degrees of persistence of interest in the PPP literature. This means that tests based on size-adjusted critical values are unlikely to reject stationarity whether long run PPP holds or not. Thus, we learn very little from conducting tests with size-corrected critical values except in the rare case of a rejection of stationarity. Our example of the problems with interpreting results of stationarity tests is representative for a wide range of applications in macroeconomics and international finance. We conclude that these tests should not be used without size-adjusting the critical values and will tend to be of limited usefulness even with size-adjustments unless the sample size is very large.

In Section 2, we review the construction of the KPSS and LMC tests of stationarity. In Section 3 we document the size distortions of the KPSS and LMC tests based on asymptotic critical values. In Section 4, we illustrate the practical importance of the size distortions for applied work in the context of the PPP debate. In Section 5, we analyze the size-corrected power of the LMC and KPSS tests and reexamine the empirical findings. The conclusions are given in Section 6.

## 2. A review of the two leading examples of tests of stationarity

The two most widely used tests of the  $I(0)$  null hypothesis are due to Kwiatkowski et al. (1992) and to Leybourne and McCabe (1994). These two tests differ in how they account for serial correlation under  $H_0$ . Whereas the KPSS test uses a nonparametric correction similar to the Phillips–Perron test, the LMC test allows for

additional autoregressive lags similar to the augmented Dickey–Fuller (ADF) test. Although both tests have the same asymptotic distribution, the LMC test statistic converges at rate  $O_p(T)$  compared to a rate of only  $O_p(T/l)$  for the KPSS statistic where  $l$  is the autocorrelation truncation lag. Moreover, the LMC test is robust to the choice of lag order, whereas the KPSS test can be sensitive to the choice of  $l$  (Leybourne and McCabe, 1994; Lee, 1996).

### 2.1. Leybourne–McCabe test

Following Leybourne and McCabe (1994), we consider the generalized local levels model

$$\Phi(L)y_t = \alpha_t + \beta t + \epsilon_t \quad (1)$$

and

$$\alpha_t = \alpha_{t-1} + \eta_t, \quad \alpha_0 = \alpha, \quad t = 1, \dots, T \quad (2)$$

where  $\Phi(L) = 1 - \phi_1 L - \phi_2 L^2 - \dots - \phi_p L^p$  is a  $p$ th-order autoregressive polynomial in the lag operator  $L$  with roots outside the unit circle. We assume that  $\epsilon_t$  is distributed iid  $(0, \sigma_\epsilon^2)$  and  $\eta_t$  is distributed iid  $(0, \sigma_\eta^2)$ . We also assume that  $\epsilon_t$  and  $\eta_t$  are mutually independent. Under regularity conditions, the structural model (1) and (2) can be shown to be second-order equivalent in moments to the ARIMA( $p, 1, 1$ ) reduced form process

$$\Phi(L)(1-L)y_t = \beta + (1-\theta L)\zeta_t \quad (3)$$

with suitably defined MA coefficient  $\theta$  and iid innovations  $\zeta_t$  with distribution  $(0, \sigma_\zeta^2)$ . It can be shown that  $0 < \theta < 1$  for  $0 < \sigma_\eta^2 < \infty$ . This specification accounts for the presence of a nonzero MA(1) component in the growth rates of many economic time series. A test of the null hypothesis that  $y_t$  follows a trend-stationary ARIMA( $p, 0, 0$ ) process against the alternative of an ARIMA( $p, 1, 1$ ) model with positive MA coefficient can be stated as  $H_0: \sigma_\eta^2 = 0$  against  $H_1: \sigma_\eta^2 > 0$  in the structural model with  $\beta \neq 0$ .

To implement the LMC test we construct the series

$$y_t^* = y_t - \sum_{i=1}^p \phi_i^* y_{t-i}$$

where the  $\phi_i^*$  are the maximum likelihood estimates of  $\phi_i$  from the fitted ARIMA( $p, 1, 1$ ) model

$$\Delta y_t = \beta + \sum_{i=1}^p \phi_i \Delta y_{t-i} + \zeta_t - \theta \zeta_{t-1} \quad (4)$$

and then calculate the residuals from the least-squares regression of  $y_t^*$  on an intercept and deterministic time trend. Denoting these residuals  $\hat{\epsilon}_t$ , the test is based on

$$\hat{s}_\beta = \hat{\sigma}_\epsilon^{-2} T^{-2} \hat{\epsilon}' V \hat{\epsilon}$$

where  $\hat{\sigma}_\epsilon^2 = \hat{\epsilon}'\hat{\epsilon}/T$  is a consistent estimator of  $\sigma_\epsilon^2$  and  $V$  is a  $T \times T$  matrix with  $ij$ th element equal to the minimum of  $i$  and  $j$ . We reject the null hypothesis of stationarity if the test statistic exceeds its critical value under  $H_0$ .

If  $\beta$  is known to be zero in population, the residuals  $\hat{\epsilon}_t$  are obtained from regressing  $y_t^*$  on an intercept alone. The resulting test statistic is

$$\hat{s}_\alpha = \hat{\sigma}_\epsilon^{-2} T^{-2} \hat{\epsilon}' V \hat{\epsilon}$$

Asymptotic critical values for both of these statistics are provided in Kwiatkowski et al. (1992). We follow Leybourne and McCabe in programming the test in GAUSS. A key issue in the implementation of the LMC test that is not discussed in their paper is the choice of starting values for the ARIMA( $p,1,1$ ) model. Rather than rely on the standard optimization algorithm used by the GAUSS–ARIMA routine, Leybourne and McCabe evaluate the likelihood function for a grid of initial values for the moving average parameter,  $\theta^0$ , ranging from 0 to  $-1$  in increments of 0.05, with the initial value of the autoregressive parameter(s) fixed at  $\theta^0 - 0.1$ . In particular, for  $p=1$ , the initial guess for the AR parameter is defined as  $\phi_1^0 = \theta^0 - 0.1$ . For  $p>1$ , the initial guess is  $\phi_1^0 = \dots = \phi_p^0 = \theta^0 - 0.1$ . The starting value for the drift parameter is set equal to 0.1. In this paper, we extend Leybourne and McCabe's procedure by including among the candidate models the model selected based on the default initial values supplied by the GAUSS–ARIMA routine. The model that achieves the highest likelihood is selected for the final analysis. The GAUSS code for our estimation procedure is available upon request.<sup>2</sup>

## 2.2. KPSS test

The KPSS test of stationarity is based on the same model as the LMC test and has the same general structure. The KPSS test statistic for the model with time trend is computed as

$$\hat{d}_\beta = \hat{\sigma}_\epsilon^{-2} T^{-2} \hat{\epsilon}' V \hat{\epsilon}$$

where  $\hat{\epsilon}_t$  is the least-squares residual from a regression of  $y_t^*$  on an intercept and deterministic time trend. The difference to the LMC test is that the KPSS test relies on a nonparametric estimator of the long-run variance of  $\epsilon_t$

$$\hat{\sigma}_\epsilon^2 = \hat{\epsilon}'_t \hat{\epsilon}_t / T + 2 \sum_{i=1}^l w(i,l) \hat{\epsilon}'_t \hat{\epsilon}_{t-i} / T$$

where  $w(i,l) = 1 - i/(l+1)$  is the Bartlett kernel. This estimator is consistent if the trunc-

<sup>2</sup> It can be shown that this modified algorithm results in considerably lower size distortions than use of the initial values supplied by the GAUSS–ARIMA routine, if the test is based on asymptotic critical values. Hobijn et al. (1998) use yet another procedure for initializing the GAUSS–ARIMA routine based on Yule–Walker estimates of the model under the null hypothesis. This choice of starting values has no theoretical justification under the alternative hypothesis. In this paper, we therefore rely on the procedure originally proposed by Leybourne and McCabe.

ation lag  $l$  increases with the sample size at a suitable rate. We set  $l = \text{int}[12(T/100)^{1/4}]$  where  $\text{int}$  denotes the integer part (Kwiatkowski et al., 1992; Lee, 1996).<sup>3</sup>

Similarly, for  $\beta=0$ , the residuals  $\hat{\epsilon}_t$  are obtained from regressing  $y_t^*$  on an intercept alone. The resulting test statistic is

$$\hat{d}_\alpha = \hat{\sigma}_\epsilon^2 T^{-2} \hat{\epsilon}' V \hat{\epsilon}$$

where  $\hat{\sigma}_\epsilon^2$  is defined as before. The asymptotic critical values for these statistics are identical to those for the LMC test.

### 3. Evidence of size distortions

This is not the first paper to examine the size of tests of stationarity. For example, Kwiatkowski et al. (1992) and Lee (1996) have provided size results for a range of sample sizes and values of  $\rho$ . However, their results are limited to the AR(1) model with slope parameter  $\rho \leq 0.8$ . Kwiatkowski et al. make the case that “ $\rho=0.8$  is a plausible parameter value since, if we take most series to be stationary, their first-order autocorrelations will often be in this range” (pp. 171–172). This view may be plausible for some of the annual Nelson and Plosser (1982) data analyzed in Kwiatkowski et al., but it is highly unrealistic for most monthly and quarterly data.

In this paper, we make the case that many econometric applications of stationarity tests involve processes with roots much closer to unity (Rudebusch, 1993; Cheung and Chinn, 1997). While Leybourne and McCabe (1994) provide some additional small-sample evidence for the size of the LMC and KPSS tests, the low size distortions they find for the LMC test appear to be due to a programming error. Moreover, their evidence is limited to processes with roots between 0 and 0.9. As we will show, there is reason to expect the dominant root of many stationary processes to be closer to 0.94–0.99 in practice. Thus, the relevant models from an economic point of view are a highly persistent process under the null of stationarity and a unit root process under the alternative. There is reason to doubt the finite-sample accuracy of the asymptotic critical values for such highly persistent processes.<sup>4</sup> We illustrate this point by extending the simulation evidence for the KPSS test and the LMC test to processes with larger roots. We use the critical values compiled by Kwiatkowski et al. (1992) and used in most applied work.<sup>5</sup>

The size of the KPSS test is highly sensitive to the choice of the truncation lag

<sup>3</sup> Lee (1996) shows that some slight improvements may be possible if we use data-based selection procedures for  $l$ , but the differences tend to be small in practice.

<sup>4</sup> After the first version of this paper was written, we became aware of a related paper by Rothman (1997) that makes a similar point. However, Rothman does not actually provide estimates of the size of the test. Moreover, his study was limited to the KPSS test with trend, and he narrowly focused on one AR(2) DGP with a root of 0.927,  $T=175$  and  $l \leq 10$ .

<sup>5</sup> Sephton (1995) provides slightly more accurate critical values, but the differences are negligible for sample sizes in excess of 100.

*l*. We therefore follow the recommendation of Kwiatkowski et al. (1992) and Lee (1996) and choose a comparatively large value of *l* such that  $l = \text{int}[12(T/100)^{1/4}]$ . This choice tended to produce the most accurate test results in previous studies. For the LMC test we set  $p=1$ , since the size of the test is not sensitive to the lag order used. The data generating process is an AR(1) process with root  $\rho$  and NID(0,1) innovations. The sample size is  $T \in \{100, 300, 600\}$ . Table 1 shows the effective size of both the KPSS and the LMC test. Results for the model without trend are shown in Table 1a and those for the model with trend in Table 1b. We focus on the nominal 5% test. Qualitatively similar results are obtained at the nominal 10% level.

Table 1a shows the rejection rate under the null hypothesis for a range of values of  $\rho$  from 0 to 0.99. It is evident that the size distortions for roots near unity are large and increasing, unlike the size results reported in Kwiatkowski et al. (1992), Leybourne and McCabe (1994) and Lee (1996).<sup>6</sup> For example, for  $\rho=0.9$  and  $T=100$ ,

Table 1

Effective size of the Leybourne–McCabe test and the KPSS test of the null hypothesis of stationarity using asymptotic critical values for the nominal 5% level (Based on 20 000 Monte Carlo trials and data generating process  $y_t = \rho y_{t-1} + \zeta_t$  with NID(0,1) innovations.  $l = \text{int}[12(T/100)^{1/4}]$  where int denotes the integer part. The asymptotic critical values are from Kwiatkowski et al. (1992).)

$\rho$	Rejection rates (%)					
	$T=100$		$T=300$		$T=600$	
(a) No trend	$\hat{d}_\alpha(l)$	$\hat{s}_\alpha(1)$	$\hat{d}_\alpha(l)$	$\hat{s}_\alpha(1)$	$\hat{d}_\alpha(l)$	$\hat{s}_\alpha(1)$
0	3.1	5.8	4.6	5.3	4.4	5.0
0.5	4.4	8.2	5.6	5.5	5.5	5.4
0.7	6.3	11.4	8.4	6.8	6.9	5.8
0.8	8.8	17.4	9.5	8.3	8.9	6.5
0.9	17.6	32.2	18.2	12.2	16.2	8.6
0.95	29.9	55.4	33.2	27.2	30.6	13.9
0.98	44.9	70.8	56.8	61.5	59.5	45.2
0.99	51.2	74.4	68.6	76.7	76.3	69.6
(b) Trend	$\hat{d}_\beta(l)$	$\hat{s}_\beta(1)$	$\hat{d}_\beta(l)$	$\hat{s}_\beta(1)$	$\hat{d}_\beta(l)$	$\hat{s}_\beta(1)$
0	3.6	5.4	4.4	5.4	4.6	5.2
0.5	5.1	6.2	6.0	5.7	6.0	5.4
0.7	7.3	7.1	7.9	6.0	7.9	5.8
0.8	9.8	8.9	11.2	6.4	10.6	5.8
0.9	18.6	21.4	23.5	7.4	21.7	6.4
0.95	29.5	38.0	45.4	17.9	45.5	8.9
0.98	38.8	49.7	69.1	46.3	76.7	32.1
0.99	40.7	51.9	76.5	57.9	87.9	54.3

<sup>6</sup> We were unable to replicate the size results for the LMC test reported in Leybourne and McCabe (1994) even using the GAUSS code provided to us by Steve Leybourne. Even for processes with low persistence, we find much higher size distortions for the LMC test than originally reported.

the rejection rate of the nominal 5% LMC test based on conventional asymptotic critical values is 32%. For  $\rho=0.99$  and  $T=100$ , the rejection rate rises to 74%. Even for  $T=600$ , the rejection rate may be as high as 70 (45, 14, 9)% for  $\rho=0.99$  (0.98, 0.95, 0.9). Similarly, the KPSS test rejects the null hypothesis in up to 77% of all trials. Based on this evidence, one would expect both tests to reject the null hypothesis of stationarity far too often in small samples. Qualitatively similar results hold for the model with trend in Table 1b.

It is of some practical interest to compare the performance of the LMC and the KPSS test. For the model without trend, the KPSS test tends to be almost uniformly more accurate than the LMC test for  $T=100$ , for  $T=300$  the LMC test is more accurate, except for the most persistent processes, and for  $T=600$  the LMC test is uniformly more accurate. The size of both tests improves with larger sample size, but only very slowly. Consistent with the theoretical results about the rate of convergence of the two tests, the size of the LMC test converges much more rapidly to its nominal level than that of the KPSS test. However, for the relevant range of  $\rho$ , severe size distortions persist even for  $T=600$ . For the model with trend in Table 1b, the size distortions of the LMC test tend to be considerably smaller than in Table 1a. Except for  $T=100$ , the LMC test almost always is more accurate than the KPSS test, often by a wide margin. The differences are most pronounced for larger sample sizes. However, even the LMC test has rejection rates of up to 58% for  $\rho=0.99$  and  $T=300$ .

Table 1 also shows that for highly persistent stationary processes, the convergence of the size to its nominal level may be non-monotonic. As the sample size increases from  $T=100$  to  $T=300$ , the effective size actually worsens in some cases. For  $T=600$ , the effective size improves relative to  $T=300$ , but may still be higher than for  $T=100$ . The degree of non-monotonicity is more pronounced for the KPSS test than for the LMC test.

We conclude that both tests have a strong tendency to spuriously reject the null hypothesis of stationarity for realistic values of  $\rho$  and  $T$ . The existence of such severe size distortions has not been previously documented in the literature. In applied work, rejections of the stationarity hypothesis based on asymptotic critical values have often been welcomed as strong evidence in favor of a unit root (and as a formal justification for pursuing cointegration tests for linear combinations of  $I(1)$  variables). Our results suggest that many of these findings are likely to have been spurious.

## **4. Example: testing for long-run PPP in the Post-Bretton Woods era**

### *4.1. Motivation*

More than 20 years after the breakdown of the Bretton Woods exchange rate system there still is considerable disagreement over the question of whether real exchange rates are mean-reverting (Froot and Rogoff, 1995; Rogoff, 1996). While most economists find some version of long-run purchasing power parity plausible and indeed well nigh indispensable in the construction of theoretical open economy macroeconomic models, statistical tests for the absence of mean reversion to date



have yielded at best conflicting results. This makes it appealing to test directly the null hypothesis that real exchange rates are mean-reverting. A failure to reject this null hypothesis would not suffice to convince a skeptic of the existence of long-run PPP, but a rejection would be compelling evidence against long-run PPP. Such PPP tests have been conducted for example by Baillie and Pecchenino (1991) to assess the validity of the building blocks of the monetary model of exchange rate determination for the UK and the US. Kuo and Mikkola (1999) conduct a similar analysis for long-run US–UK real exchange rates. However, their analysis has no direct implications for the post-Bretton Woods period. In work more closely related to ours, Culver and Papell (1999) observe that the failure to reject the null of stationarity for real exchange rates, together with evidence against the null of stationarity for nominal exchange rates for the same sample period, would constitute strong evidence of long-run PPP. Culver and Papell investigate the null hypothesis of stationary real exchange rates in the Post-Bretton Woods era using the KPSS test. For quarterly real exchange rate data, they conclude that the evidence against long-run PPP is mixed, with the KPSS test at the 5% critical value not rejecting the null of stationarity in most cases.

What makes the application of stationarity tests to real exchange rates problematic is the fact that the mean-reversion in real exchange rates is slow. Slow mean reversion does not contradict the view that long-run PPP holds. It is well known that theoretical models with intertemporal smoothing of consumption goods (Rogoff, 1992) or cross-country wealth redistribution effects (Obstfeld and Rogoff, 1995) imply highly persistent but transitory deviations from PPP. Thus, the relevant comparison involves a highly persistent stationary null and a unit root alternative, consistent with our claim in Section 3. One would expect that the accuracy of the test depends on the value of the dominant root under the null hypothesis. Since the extent of the size distortions increases with the persistence of the process under the null hypothesis, it is essential to obtain a sense of the degree of mean reversion under the null in order to assess the potential size distortions in applied work. It is useful to reparameterize this problem in terms of the half-life of the response of the real exchange rate to a shock.

There is a consensus view in the PPP literature about the half-life of the response of the real exchange rate to a shock. For example, Abuaf and Jorion (1990, p. 173) suggest a half-life of three–five years for the post-Bretton Woods era. Rogoff (1996, pp. 657–658) conjectures that deviations from PPP dampen out at the rate of about 15% per year. Froot and Rogoff (1995, p. 1645) consider a half-life of 3–5 years quite plausible. Recently, Murray and Papell (2000) have shown that the half-life may plausibly be even larger. In what follows, we will exploit the close link between the half-life and the value of the autoregressive root in an AR(1) model,  $\rho$ , to obtain a benchmark for plausible values of  $\rho$ . The half-life of the response of the process to a shock is defined as  $h=i/f$  where  $f$  denotes the sampling frequency of the data (1/year for years; 4/year for quarters; 12/year for months, etc.) and  $i$  is defined by  $\rho^i=0.5$ . Under  $H_0$ , the value of the root  $\rho$  of the AR(1) model

$$y_t = \alpha + \rho y_{t-1} + \epsilon_t \quad (5)$$

is a function of the half-life. For example, if the half-life of an innovation is five

years under  $H_0$  and the data frequency is monthly,  $\rho=0.5^{(1/60)}=0.9885$ . For quarterly data, under the same assumptions,  $\rho=0.5^{(1/20)}=0.9659$  and for annual data  $\rho=0.5^{(1/5)}=0.8704$ . For the null hypothesis of a half-life of three years, the corresponding values are  $\rho=0.5^{(1/36)}=0.9809$  for monthly data,  $\rho=0.5^{(1/12)}=0.9439$  for quarterly data, and  $\rho=0.5^{(1/3)}=0.7937$  for annual data.

Thus, to the extent that the real exchange rate is well approximated by an AR(1) process, the simulation results in Table 1a suggest that the LMC test will reject the  $I(0)$  null with about 70% probability for monthly and about 55% probability for quarterly data, if real exchange rates indeed are stationary with half-lives of about 3–5 years. For the KPSS test the corresponding rejection rates are about 60% for the monthly data and 30% for the quarterly data. Thus, it seems all but impossible to determine in practice whether the test correctly rejects the null in favor of a unit root or whether the rejection is simply due to size distortions. We will illustrate this point in the next section.

#### 4.2. Empirical analysis

The real exchange rate data are constructed from the IMF's *International Financial Statistics* data base on CD-ROM. They are based on the end-of-period nominal US dollar spot exchange rates and the US and foreign consumer price indices. The first data set comprises monthly data for 1973.I–1997.IV (292) observations for 17 countries including Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Italy, Japan, The Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, and the United Kingdom. The second data set includes quarterly data for 1973.I–1997.IV (98 observations) for the same 17 countries plus Australia, Ireland, and New Zealand.

We begin the analysis with the LMC test of the null hypothesis of stationarity. The lag orders for the ARIMA( $p,1,1$ ) model were selected using the Akaike Information Criterion (AIC). Our results are robust to alternative assumptions about the lag order. Table 2 provides strong evidence against the null hypothesis of PPP for all countries at the monthly frequency and for all countries but Australia, New Zealand and Switzerland at the quarterly frequency. The apparent finding of a unit root in all 17 monthly and 17 of the 20 quarterly series is striking in that no other test to date has produced such strong results. If correct, these results would imply that most, if not all, real exchange rate processes contain important permanent components, implying a sharp reversal of the evidence in the literature and a direct rejection of long-run PPP.

It would be tempting to rationalize this result by appealing to theoretical explanations such as permanent changes in the relative productivity of the tradables and nontradables sector (Baumol and Bowen, 1966), permanent changes in the level of government spending (Froot and Rogoff, 1991; Alesina and Perotti, 1995), and systematic bias in CPI measurement (Shapiro and Wilcox, 1997). However, we know from Table 1 that such strong rejections are extremely likely a priori, even if the null hypothesis is true. Thus, the results of the LMC test are not informative. We cannot tell whether the test correctly rejects the null in favor of a unit root or whether the rejection is simply due to size distortions. Moreover, this problem is unlikely to

Table 2  
Testing for long-run purchasing power parity in the Post-Bretton Woods era

Country		LMC	KPSS	DF-GLS
	$\hat{p}$	$\hat{s}_\alpha(\hat{p})$	$\hat{d}_\alpha(l)$	$\hat{t}_{\phi_0}(p)$
(a) Monthly data <sup>a</sup>				
Austria	1	6.026**	0.498**	−0.948
Belgium	7	2.045**	0.248	−1.581
Canada	1	9.591**	0.670**	−0.581
Denmark	3	4.212**	0.299	−1.426
Finland	1	0.550**	0.181	−1.501
France	1	1.663**	0.223	−1.742
Germany	3	3.959**	0.277	−1.598
Greece	2	5.032**	0.349*	−1.850*
Italy	3	6.320**	0.454*	−1.882*
Japan	1	17.313**	1.324	−0.866
Netherlands	3	3.238**	0.225	−1.570
Norway	4	2.759**	0.197	−1.404
Portugal	7	4.681**	0.487**	−1.441
Spain	1	1.229**	0.479**	−1.170
Sweden	1	4.227**	0.295	−2.067*
Switzerland	1	8.906**	0.654**	−0.998
United Kingdom	1	4.054**	0.315	−1.650

(continued on next page)

be overcome by waiting for more data to accumulate. The size results in Table 1a suggest that even doubling the sample size for the monthly real exchange rate to about 600 observations would do little to improve the accuracy of the test.

The second column of Table 2 shows the corresponding results for the KPSS test. Recall that our size results in Table 1a suggested that the KPSS test will tend to have lower size distortions than the LMC test for the sample sizes and degrees of persistence of relevance to the PPP debate. This fact is consistent with the observation that in Table 2 there are far fewer rejections for the KPSS test than for the LMC test. However, the number of rejections using the KPSS test is smaller (and that of the LMC test larger) than suggested by the simulation evidence.

It is interesting to compare our findings to the results of previous studies. For our choice of  $l$ , Culver and Papell (1999) reject the null of stationarity at the quarterly frequency for Australia, Ireland, and Japan.<sup>7</sup> Using our updated sample, we obtain the same rejections for the quarterly data plus Canada and Switzerland. In contrast, at the monthly frequency, the KPSS test rejects the null of stationarity for seven of 17 countries (Austria, Canada, Greece, Italy, Portugal, Spain, Switzerland). This pat-

<sup>7</sup> Using smaller values of  $l$ , they reject the null of stationarity for 10 of their 17 countries. This result is consistent with evidence in Kwiatkowski et al. (1992) and Lee (1996) that small values of  $l$  tend to result in spurious rejections of the null hypothesis.

Table 2 (continued)

Country		LMC	KPSS	DF-GLS
	$\hat{\rho}$	$\hat{s}_{\alpha}(\hat{\rho})$	$\hat{d}_{\alpha}(l)$	$\hat{t}_{\phi_0}(p)$
(b) Quarterly data <sup>b</sup>				
Australia	1	0.134	0.472**	−1.311
Austria	1	2.324**	0.265	−2.060*
Belgium	3	0.981**	0.134	−2.424**
Canada	3	2.673**	0.365*	−1.206
Denmark	3	1.305**	0.166	−2.010*
Finland	3	0.539**	0.100	−2.327**
France	2	1.100**	0.127	−2.581**
Germany	1	1.355**	0.152	−2.521**
Greece	1	1.751**	0.190	−2.270*
Ireland	2	3.697**	0.457*	−1.459
Italy	1	2.114**	0.252	−2.543**
Japan	1	6.383**	0.681**	−0.734
Netherlands	3	0.898**	0.126	−2.531**
Norway	2	0.989**	0.110	−2.369**
New Zealand	1	0.165	0.194	−2.455**
Portugal	1	2.540**	0.258	−2.079*
Spain	1	1.304**	0.259	−2.319**
Sweden	3	1.203**	0.165	−2.741**
Switzerland	1	0.081	0.354*	−1.857
United Kingdom	1	1.536**	0.205	−2.367**

<sup>a</sup> All real exchange rates are constructed from IFS CD-ROM data on consumer price and end-of-period US\$ exchange rates. Monthly data are for 1973.I–1997.4 (292 observations).  $\hat{\rho}$  refers to the Akaike Information Criterion (AIC) lag order estimate of the ARIMA( $p,1,1$ ) model. Lag orders are constrained to lie between 0 and 8.  $l=\text{int}[12(T/100)^{1/4}]$  where int denotes the integer part. For the DF-GLS test the lag order is selected using a sequential  $t$ -test with an upper bound of  $p=12$ . At the 5 (10)% significance level, the asymptotic critical value for the LMC and the KPSS test is 0.463 (0.347). The finite-sample critical values for the DF-GLS test are –2.086 (–1.760). \*\* (\*) denotes a rejection at the 5 (10)% level.

<sup>b</sup> All real exchange rates are constructed from IFS CD-ROM data on consumer price and end-of-period US\$ exchange rates. Quarterly data are for 1973.I–1997.II (98 observations).  $\hat{\rho}$  refers to the AIC lag order estimate of the ARIMA( $p,1,1$ ) model. Lag orders are constrained to lie between 0 and 3 for the quarterly data.  $l=\text{int}[12(T/100)^{1/4}]$  where int denotes the integer part. For the DF-GLS test the lag order is selected using a sequential  $t$ -test with an upper bound of  $p=8$ . At the 5 (10)% significance level, the asymptotic critical value for the LMC and the KPSS test is 0.463 (0.347). The finite-sample critical values for the DF-GLS test are –2.308 (–1.964). \*\* (\*) denotes a rejection at the 5 (10)% level.

tern is consistent with the evidence of increasing size distortions, as  $\rho$  and  $T$  are increased, for both the LMC and KPSS test (Table 1a).

As in the case of the LMC test, the observed rejections of the stationarity null by the KPSS test are not informative, given the size distortions of the KPSS test based on asymptotic critical values. It is quite possible that the observed rejections are spurious. This view is supported by test results for the asymptotically efficient DF-GLS test of the unit root hypothesis. We focus on this test because its power compares favorably to standard ADF tests (Elliott et al., 1996; Cheung and Lai, 1998). The DF-GLS test for the case of unknown mean is based on the following regression

$$(1-L)y_t^\mu = \phi_0 y_{t-1}^\mu + \sum_{j=1}^p \phi_j (1-L)y_{t-j}^\mu + \zeta_t$$

where  $y_t^\mu$ , the locally demeaned process under the local alternative of  $\bar{\rho}=1+\bar{c}/T$ , where  $\bar{c}<0$  is given by

$$y_t^\mu = y_t - z_t \beta$$

with  $z_t=1$  and  $\beta$  being the least-squares regression coefficient of  $\tilde{y}_t$  on  $\tilde{z}_t$ , the latter being defined by  $\tilde{y}_t=[y_1, (1-\bar{\rho}L)y_2, \dots, (1-\bar{\rho}L)y_T]'$  and  $\tilde{z}_t=[z_1, (1-\bar{\rho}L)z_2, \dots, (1-\bar{\rho}L)z_T]'$ . The DF-GLS test statistic is given by the  $t$ -ratio for testing  $H_0: \phi_0=0$  against the one-sided alternative  $H_0: \phi_0<0$ . Implementation of the test requires the choice of the parameter  $\bar{c}$ . We follow Elliott et al.'s recommendation and set  $\bar{c}=-7$ .

Rather than using the asymptotic critical values for the DF-GLS test we rely on approximate finite-sample critical values. Finite-sample critical values under the unit root null hypothesis may be obtained by simulation as described in Elliott et al. (1996). We depart from that procedure in that we allow for some serial correlation under the null hypothesis. We postulate an ARIMA(0,1,1) model, consistent with the assumptions of the LMC and KPSS tests, with  $\theta=0.25$ . This specification accounts for the presence of a small nonzero MA(1) component in the growth rates of many economic time series, including real exchange rates (Froot and Rogoff, 1996; Lothian and Taylor, 1996; Canzoneri et al., 1999; Engel and Kim, 1999). In fitting the ADF model and in calculating the finite sample critical values, we use sequential  $t$ -tests with upper bounds of eight autoregressive lags in the quarterly case and 12 lags in the monthly case. Thus, our critical values allow for lag order uncertainty.

For the same data set, for which the LMC test (and to a lesser extent the KPSS test) find strong evidence against stationarity, Table 2 shows that the 5 (10)% DF-GLS test rejects the unit root null hypothesis for 3 (0) of the 17 countries for which monthly data are available and for 11 (15) of the 20 countries for which quarterly data are available.<sup>8</sup> In fact, for several countries the test results for the DF-GLS test directly contradict those for the stationarity tests. For example, for Greece and Italy the KPSS test rejects stationarity at the monthly frequency, yet the DF-GLS test rejects the unit root null hypothesis. No such contradictions occur at the quarterly frequency. For the LMC test the contradictions are more numerous and include three countries for the monthly data and 14 countries for the quarterly data.

Of course, it is possible that some of these contradictions are driven by size distortions of the DF-GLS test. Investigating that possibility would be beyond the scope of this paper. More importantly, even if it could be shown that these obvious contradictions disappear, as the critical values of the DF-GLS test are adjusted, the fact

<sup>8</sup> Cheung and Lai (1998) analyze three of the 17 monthly real exchange rates used in our study using the same DF-GLS test. They are able to reject the unit root hypothesis for the UK, France, and Germany. We obtain similar results for France and Germany, but not for the UK. The difference in the results is driven by the sample period.

remains that the KPSS test and LMC tests have a tendency to reject the null of long-run PPP, even when it is true.

Our example of the problems in interpreting the results of stationarity tests is not an isolated case. The apparent tendency of the KPSS and LMC tests to reject the null hypothesis of stationarity in empirical work has been noted by other researchers. For example, Cheung and Chinn (1997, p. 71) reported rejections of the null hypothesis of trend stationarity for quarterly US GNP at the 1% level based on asymptotic critical values. Several other researchers remarked on the decisive nature of their evidence against stationarity. Our evidence that the LMC and KPSS tests suffer from severe size distortions provides a plausible explanation of the source of these ‘strong’ rejections of stationarity. The next section will investigate the extent to which the use of size-adjusted critical values can overcome the problems of interpreting the results of stationarity tests.

## 5. Size-adjusted power under economically plausible assumptions

One might conjecture that the size distortions of stationarity tests could be overcome easily by the use of appropriately adjusted finite sample critical values. Indeed, that strategy has been pursued in recent papers by Cheung and Chinn (1997), Rothman (1997) and Kuo and Mikkola (1999). However, as this section will illustrate, such corrections inevitably result in a dramatic loss of power.

Under the null hypothesis  $H_0: \sigma_\eta^2=0$ , the local levels model underlying the LMC and KPSS test reduces to a stationary process. Thus, it is straightforward to construct finite-sample critical values from an approximating stationary AR( $p$ ) model. Note that finite-sample critical values derived from such a parametric model violate the nonparametric spirit of the KPSS test, but are consistent with the parametric assumptions of the LMC test. We nevertheless will examine the performance of both tests using size-adjusted critical values.

The power of stationarity tests based on size-adjusted critical values will clearly depend on the persistence of the process under the null. Thus, we know that power may be arbitrarily low in general. The only interesting question is what the power of the test will be for models under the null hypothesis that are economically plausible. One appealing way of parameterizing the persistence of the process under the null is to appeal to the emerging consensus in the PPP literature about the value of the half-life of shocks to the real exchange rate. By definition, models that are consistent with this consensus must be considered economically plausible. As shown in Section 4.1, in the context of the AR(1) model, the half-life consensus translates into roots between 0.986 and 0.989 for monthly data and between 0.944 and 0.981 for quarterly data. We therefore calculate size-adjusted critical values under the hypothetical assumption that the true process is a stationary AR(1) process with degrees of persistence corresponding to the upper and lower bound of the half-life consensus.

Our approach differs from the usual approach of bootstrapping the model under the null as implemented for example by Kuo and Mikkola (1999). Note that here we are interested not in finding the *statistically* most plausible model of the data

generating process under the null of stationarity (which is what the bootstrap approach aims to do), but in assessing the *potential* power of the test under *economically* plausible assumptions about the speed of convergence to PPP under the null. We focus on  $T=100$  and  $T=300$ . These are representative sample sizes for quarterly and monthly real exchange rate data under the recent float. The size-adjusted critical values for this AR(1) process differ greatly from their asymptotic counterparts. For example, for a half-life of three years and quarterly data the 5% critical value for the KPSS (LMC) test is 0.698 (5.893) compared with the asymptotic critical value of 0.463. For monthly data these values rise to 1.438 and 17.210, respectively. For a half-life of five years and quarterly data the size-adjusted critical values are 0.749 for the KPSS test and 7.271 for the LMC test; for monthly data and a half-life of five years we obtain critical values of 1.590 for the KPSS test and 21.426 for the LMC test.<sup>9</sup>

In Table 3, we use our critical values to compute the size-adjusted power of the KPSS and LMC tests against the ARIMA(0,1,1) alternative with  $\theta=0.25$ . The latter process is the same process used to construct the critical values for the DF-GLS test. Table 3 suggests three conclusions. First, the size-adjusted power may be as low as 20% for the KPSS test and as low as 22% for the LMC test. This means that only in the rare case of a rejection of the null hypothesis will the test shed light on the question of whether long-run PPP holds or not. In the absence of a rejection, test results based on finite-sample critical values are not going to be informative. Second, for a given test, size-adjusted power is generally higher for monthly data than for quarterly data. Third, the LMC test tends to have higher size-adjusted power than the KPSS test for the same process. For example, for monthly data and a half-life of five (three) years under the null, the LMC test detects the unit root process probability 26.8% (42.5%) compared with 21.7% (31.7%) for the KPSS test. Of course,

Table 3

Power (in %) of the LMC and KPSS tests of the null hypothesis of level stationarity based on size-adjusted critical values (Based on 20 000 trials from  $\Phi(L)(1-L)y_t=(1-\theta L)\zeta_t$  with  $\theta=0.25$  and NID errors. Power is calculated using size-corrected critical values under the hypothesized AR(1) null)

	$H_0$ : Half-life of three years		$H_0$ : Half-life of five years	
	$\rho=0.9439$ ( $T=100$ )	$\rho=0.9809$ ( $T=300$ )	$\rho=0.9659$ ( $T=100$ )	$\rho=0.9885$ ( $T=300$ )
KPSS	28.5	31.7	19.8	21.7
LMC	36.7	42.5	22.2	26.8

<sup>9</sup> It is important to note that these size-adjusted critical values differ from the conventional finite-sample critical values used for example by Culver and Papell. The latter are derived under the counterfactual assumption that the data generating process is white noise. While they allow for the estimation of higher-order models and adjust the critical values for the sample size, they do not adjust for the persistence of the process under the stationarity null. Thus, they are closer in spirit to the asymptotic critical values suggested by Kwiatkowski et al. (1992) than to our critical values.

this result may be an artifact of the parametric nature of the data generating process which favors the LMC test.

Clearly, if the true process for the real exchange rate is stationary, it need not follow an AR(1) process. Nevertheless, the size-corrected critical values based on the AR(1) model provide a useful benchmark. For example, if we had used these finite-sample critical values for a half-life of five years in Table 2, none of the test statistics for the monthly data would have been significant and only the Japanese test statistic for the quarterly data. For a half-life of three years, both tests would have rejected stationarity for the Japanese quarterly data, but only the LMC test for the Japanese monthly data. For no other country stationarity would have been rejected. Of course, given the low power of the test for economically plausible models, this outcome is not unexpected.

Since stationarity tests are almost as likely not to reject the null because of low power as they are likely not to reject because stationarity indeed holds, the fact that rejections rarely occur cannot be interpreted as convincing evidence in favor of long-run PPP. Thus, there is little value added from conducting stationarity tests with size-adjusted critical values, except in rare cases like Japan, for which there is some evidence against long-run PPP. This thought experiment suggests that tests of the null hypothesis of stationarity will tend to be useful only for sample sizes much larger than those used in the PPP debate. While the further theoretical development of such tests continues at a rapid pace, their usefulness for applied work is open to question.

## **6. Conclusions**

It is common in empirical work to test the null hypothesis of stationarity against the alternative of a unit root process. We showed that the use of conventional asymptotic critical values for commonly used stationarity tests may cause extreme size distortions, if the model under the null hypothesis is highly persistent. The existence of such size distortions is not surprising from the point of view of econometric theory. It is merely the mirror image of the well-known problem of low power of unit root tests against local alternatives. Nevertheless, few applied users appear to be aware of the potential pitfalls of using tests of the stationarity null. There is a widespread belief that these tests — in conjunction with tests of the unit root null — provide compelling evidence about the true order of integration of the underlying series. The aim of this paper has been to alert applied users to the fact that this perception often is misleading. In fact, we showed that such confirmatory data analysis will tend to favor the unit root hypothesis, regardless of whether it is true.

In most applications of stationarity tests in empirical macroeconomics and in international finance the process under the null hypothesis will be highly persistent. Given our evidence of large size distortions for realistic degrees of persistence and sample sizes, one would expect stationarity tests to reject the null hypothesis of stationarity far too often, even if the true model is stationary. Thus, the common practice of viewing tests of the null hypothesis of stationarity as complementary to tests of the



unit root null must be regarded as questionable. Given the low power of unit root tests against highly persistent alternatives, this practice will tend to result in spurious acceptances of the unit root hypothesis.

We stress that our simulation evidence is limited to the two stationarity tests most widely used in applied work, the KPSS and the LMC test. Further research will be needed to establish whether similar conclusions hold for other tests of the null hypothesis of stationarity. For example, Choi (1994) proposed a modification of the KPSS test. Unlike the KPSS and LMC tests, this test does not appear to have been used in applied work, however. The tentative simulation evidence for the size and power of this test provided by Choi (1994) suggests that his test will have better size properties than the KPSS test for large samples, but worse size properties for small samples. Thus, no one test is most accurate in all situations. It appears unlikely that any test of stationarity can ever be designed that completely overcomes the small-sample size distortions we document and retains reasonable power, but additional research into the tradeoffs between alternative stationarity tests for a given sample size of interest is likely to help applied researchers to make an informed choice between alternative tests and to interpret test results obtained in practice.

We illustrated the practical importance of the size distortions of the KPSS and LMC tests for testing the hypothesis of long-run PPP under the recent float. The results of stationarity tests based on asymptotic critical values were shown to be potentially very misleading and difficult to interpret in practice. Consistent with our simulation evidence, we found stronger evidence against long-run PPP based on the LMC test than based on the KPSS test. However, we showed that both tests are likely to overstate the evidence against long-run PPP. We also showed that if the same test is used with size-corrected critical values based on economically plausible models, the size-adjusted power of the test drops sharply, and the observed failures to reject stationarity cannot be interpreted as convincing evidence in favor of mean reversion in real exchange rates. Only in the rare case that stationarity is rejected after size adjustments do these tests shed light on the PPP question. We concluded that tests of the null hypothesis of stationarity (and by extension tests of the null hypothesis of cointegration) are of limited usefulness for the PPP debate and by extension for other empirical work with monthly and quarterly data based on small samples.

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