

Abstract: A Primer on Exchange Rates

Over the past three decades the literature investigating exchange-rate behavior has become voluminous. This paper provides an interpretive survey of that literature. It begins with a discussion of basic theory. It then goes on to review the empirical literature on purchasing power parity (PPP). The upshot of these studies is that over long periods, and for countries with substantial differences in price-level behavior, the PPP hypothesis is a tolerably good first approximation. Much less knowledge of exchange-rate behavior over shorter time horizons is available. Nevertheless, researchers have made considerable strides over the past decade in filling in the blanks here and chipping away at the major puzzles surrounding exchange-rate behavior over such horizons – the so-called “PPP puzzle” and the so-called “exchange rate disconnect puzzle.” The paper concludes with a review of the empirical literature on this subjects.