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Book Review

Book Review: The Big Mac Index: Applications of Purchasing Power Parity

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Li Lian Ong (2003):

The Big Mac Index: Applications of Purchasing Power Parity

Palgrave Macmillan, Basingstoke, 144 pages, ISBN 1-4039-0310-7, GBP 47.50 cloth.

In this short volume -- partly drawn from her doctoral thesis -- LI LIAN ONG reviews the research on purchasing power parity (PPP) and applies the concept to study a number of questions related to the international comparison of prices and wages. The key innovative feature is the use of the prices of Big Macs to test for PPP and as a numeraire to control for international differences in purchasing power. The Big Mac Index itself has been published by *The Economist* since 1986. Although only meant to be a tongue-in-cheek measure of PPP-based equilibrium exchange rates, it has featured in a number of more recent research papers.

The book contains six chapters. The first two are surveys of the PPP literature. *Chapter 1* discusses the concept in general, focusing in particular on the various methodological problems involved in testing for PPP. These include the problem of choosing an appropriate price index (the "index-number problem") and the effect of productivity growth differences between the traded and non-traded goods sectors (the "productivity bias problem"). While the historical origins of PPP are covered well, the survey seems a little outdated, with the most recent reference dated 1996. *Chapter 2* (co-authored with YIHUI LAN) provides a useful review of the empirical literature on PPP. While some of the more recent work is missing, the chapter contains a neat classification of past results.

The remaining chapters feature four papers published by ONG between 1997 and 2000. The best-known of these is *Chapter 3*, based on ONG's 1997 article in the *Journal of International Money and Finance*, which provides a detailed analysis of the Big Mac Index. ONG's key results are that Big Mac parities are accurate predictors of actual exchange rates, and that the non-traded component accounts for more than 90% of the cost of a Big Mac. It is somewhat surprising that the author did not extend the data set beyond 1994 (where it ended in her original work) for this volume. Beside this, I fear that the positive results on the validity of PPP are partly driven by the choice of the U.S. dollar as numeraire currency. Had the author chosen a currency typically more over- or undervalued (compared to the other currencies in the sample), such as the Australian dollar or the Swiss Franc, the results might have been quite different. It would have also been interesting to know how more typical tests of PPP (e.g. panel unit root tests) would have fared with these data.

Chapter 4 contains a four-page essay on the Asian currency crisis. In it, ONG argues that the imminent depreciation of the major Asian currencies could have been predicted by the Big Mac Index in early 1997. The remaining two chapters feature international comparisons of the purchasing power of earnings. In *Chapter 5*, ONG analyses earnings data averaged across twelve professions. In *Chapter 6* (co-authored with JASON MITCHELL), she compares earnings of academics in eight English-speaking countries. In both cases she uses the Big Mac Index to adjust the nominal earnings data for international differences in purchasing power. Both chapters illustrate how important it is to control for international price differences when the local purchasing power of earnings is compared. Although probably of limited academic importance, these two chapters may be of particular interest to companies or individuals considering international relocation.

On the whole, this book provides a useful introduction to research on PPP, spiced up by entertaining case studies. Nevertheless, from an academic point of view it also has its flaws. First, the analysis could have been made more up-to-date. Second, the reader remains somewhat unconvinced that a Big Mac is really the “perfect universal commodity”, as it is frequently referred to in the book. While it is largely standardised, it is also a non-tradable good and far from representative of the typical consumption basket. Third, given that ONG was one of the first researchers working on PPP to analyse micro-level price data, it is surprising not to find any discussion of other work that has gone down that route. The use of direct prices of individual goods has been a major step forward in PPP research. Recent studies have featured the prices of cars, IKEA furniture, items in duty-free stores, the disaggregated price data provided by the OECD, and the price surveys released by the Economist Intelligence Unit. A chapter surveying this work and comparing the various price series – including the Big Mac Index – would have been extremely interesting.

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