Exchange Rate Modeling:
An Informal, Academic Perspective

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“Academic” for Two Reasons:

- Avoid important but (currently) insoluble problems
- Different meanings of “academic”

A Bald View of the State of the Art:

- To a good first approximation, there are essentially no *consistent strong* links between exchange rates and the macro-economy for low-inflation countries of reasonable income
  - True of *determinants* and *effects* of exchange rates
  - True of exchange rate *levels*, *volatility*, *regimes*
  - True for short- and medium-run (around 2 years)
  - True of all technical levels of empirical work

Generally Negative Impression

- Economists should be (and typically are) humble in claims of reliable linkages
- Skepticism means that occasional successes (of model/period/country/technique) are basically ignored
- Much discouragement for research in international finance

Big Effects on Research

- Theoretical implications often untested (e.g., NOEM)
- Empirics designed to avoid testable implications
    - Exchange rate regime classifications
    - Currency unions (EMU)
    - Monetary regimes for developing countries
    - Financial Integration (BWII)
    - Crises, Debt, Default
    - Long-Run focus high and rising in importance

Key (Negative) Results in Determination Literature

- Meese-Rogoff (1983) on exchange rate forecasting/determination
  - Baxter-Stockman (1989) on exchange rate regimes
  - Many on currency crises/early warning systems

A Few Exceptions

- High-Inflation (and other pathologies) have big, reasonable impact across episodes and countries
- A few Long-run effects
  - PPP – though still disputed
  - Balassa-Samuelson – relatively weak
- Fixes lower exchange rate volatility

Negative Attitude Seems Warranted

- *JIE* (2003): symposium on 20th anniversary of Meese-Rogoff with little substantial progress
- Chinn et al (2005): weak verdict on many models
    - echo of Meese-Rogoff

Even Identity of "Fundamentals" much disputed

- Trade Flows?
  - Focus of Practitioners – limited success
- Monetary?
  - Money stock (demand)
- Real?
  - Real GDP (money demand)
  - Productivity and "Balassa-Samuelson"

- Relative Prices?
  - PPP in short-run – Imbs et al (2005)
  - Terms of Trade
- Financial Flows?
  - Focus of some currency crisis work
- Financial Stocks?
  - Lane-Milesi-Ferretti and Gourinchas-Rey on NFAs and Valuation Effects

- Commodity Prices?
- Fiscal Shocks?
- Policy Shocks? (protection)
- Rate of Return shocks?
- Demographics? (long run)

Most Exchange Rate Shocks seem to be Noise

- Traditional "Fundamentals" of limited explanatory value
    - Engel-West (2005): may be inevitable result of trending fundamentals
    - Jeanne-Rose (2002) and Kilian-Taylor (2003): may be result of beliefs of chartists/noise traders

Where does this leave Central Banks?

- Little interplay between Fundamentals and exchange rates in short/medium term
    - Enormous simplification!
    - An obvious problem? Consider other long-term assets (e.g., stock and real estate markets)
- Meese-Rogoff done for FRB

Where does this leave Academics?

- Continue to avoid topic
    - Treat exchange rate as exogenous in practice
- Continuing Opportunity for new “killer app”