The Euro-Dollar exchange rate: Is it fundamental?

CAMARERO Mariam, ORDOÑEZ Javier, TAMARIT Cecilio

In this paper we have applied two different but complementary techniques and approaches to the study of the evolution of the dollar real exchange rate in relation with the Euro-area currencies. First, using dynamic panel techniques, we estimate an error correction model for the dollar real exchange rate versus seven developed countries, four of them Euro-area members. Second, we aggregate the European variables and estimate a model for the Euro-dollar real exchange rate using time series techniques. After identification and model selection, the same specification can be adopted in the two cases, in an eclectic model including real interest rate and productivity differentials, together with relative fiscal policy and net foreign asset positions. This model turns out to be compatible with the very recent results obtained in the context of the New Open Macroeconomics literature. The forecasting performance is evaluated using the aggregate model, that beats the random walk at all the forecasting horizons considered.

****