

Testing the Monetary Model of Exchange Rates: A Threshold Cointegration Approach

DUNCAN Roberto, CALDERON Cesar

Recent research has revealed the presence of threshold non-linearity in exchange rates and has shown that this type of research could explain the apparent purchasing power parity (PPP) puzzles. Theoretically, we obtain a non-linear adjustment from exchange rate models that include transaction costs. Empirically, the literature is recently using threshold autoregressive models to assess non-linearities in the adjustment to PPP. However, most of this analysis has been univariate in nature. This paper intends to: (1) Formulate a model of exchange rates with transaction costs where the fundamentals driving the exchange rate process are consistent with the monetary model. (2) We gather quarterly data of real exchange rates vis-à-vis the US for all OECD countries and emerging markets during the post-Bretton Woods period in order to test for threshold cointegration using univariate and multivariate techniques specified by Balke and Fomby (1997), and Lo and Zivot (2001). (3) We perform specification tests for the threshold model that better suits our theoretical framework by following the procedure suggested by Hansen (1999).
