Exchange Rate Modelling and Macro Fundamentals:

Failed Partnership or Open Marriage?

Professor Mark Taylor

University of Liverpool and Centre for Economic Policy research

Abstract

The paper starts with a discussion of the theory and econometric evidence relating to the major macroeconomic exchange rate models developed during the last twenty years or so, including the flexible-price monetary model; the sticky-price, overshooting monetary model; the portfolio balance model; and the equilibrium model, and then goes on to provide a brief discussion of the theory and evidence relating to the speculative efficiency of foreign exchange markets. The general conclusion to emerge from these discussions is that macroeconomic fundamentals, on the basis of the existing empirical evidence, appear to have little to do with exchange rate movements.

Beyond this, however, we aim to demonstrate that, while the macro fundamentals are clearly not capable of explaining all - or even most - of the variation in short-term nominal exchange rate movements, the research programme of the last twenty years has nevertheless not been entirely fruitless. We thus present some new empirical evidence employing panel data on twenty-one industrialized countries for the floating-rate period. Using graphical and simple econometric techniques, we show that while the macro fundamentals may be a poor guide to variations in short-run exchange rate movements (where the short run is defined as one year or less), they may nevertheless have considerable explanatory power over longer horizons, especially when large movements in the underlying fundamentals are involved.

The paper concludes that the importance of movements in macroeconomic fundamentals for exchange rate movements is a function of the size of the movements in the underlying fundamentals.