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
  o Exchange rate regime classifications
  o Currency unions (EMU)
  o Monetary regimes for developing countries
  o Financial Integration (BWII)
  o Crises, Debt, Default
  o 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
  o PPP – though still disputed
  o Balassa-Samuelson – relatively weak

• Fixes lower exchange rate volatility
Negative Attitude Seems Warranted

- *JIE* (2003): symposium on 20\textsuperscript{th} 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?
- 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”