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Journal of The Japanese and International Economies

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Expectations on the yen/dollar exchange rate – Evidence from the Wall Street Journal forecast poll

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ARTICLE INFO

Article history:

Received 6 November 2008

Revised 22 September 2009

Available online 15 January 2010

JEL classification:

F31

D84

C33

Keywords:

Foreign exchange market

Forecast bias

Random walk

ABSTRACT

Ruelke, Jan C., Frenkel, Michael R., and Stadtmann, Georg – Expectations on the yen/dollar exchange rate – Evidence from the Wall Street Journal forecast poll

We use the foreign exchange forecasts of the Wall Street Journal poll to analyze forecasters' expectation formation process for the yen against the US dollar for the period 1989–2007. We also contrast the expectation formation process with the actual exchange rate process. We find that most forecasters have contrarian and stabilizing exchange rate expectations. Our results also indicate significant heterogeneity between forecasters. However, forecasters on average underestimate the degree of contrarian and stabilizing behavior. *J. Japanese Int. Economies* **24** (3) (2010) 355–368. WHU – School of Management, Economics Department, Burgplatz 2, Vallendar, Germany.

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1. Introduction

In empirical studies of exchange rate models, typically the joint hypothesis of the validity of the examined model and rational expectations is tested. Hence, one of the reasons, why empirical studies often find little empirical support for the investigated exchange rate model, could be the violation of the rational expectation assumption in the foreign exchange market. Indeed, a number of studies have raised doubts about the validity of the rational expectations assumption in this market (e.g., Frankel and Froot, 1987a; Frankel and Rose, 1995; Menkhoff, 1998, 2001; Reitz and Slopek, 2009). In addition,

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most empirical exchange rate studies implicitly follow the assumption of traditional exchange rate models which claim that financial agents can be viewed as homogenous. However, studies of the micromarket structure suggest that there could be different groups of traders. This led several researchers to develop models in which the rational expectation assumption is relaxed and different types of actors in the currency market are considered (e.g., Frankel and Froot, 1987b, 1990; DeLong et al., 1990).

In this paper, we use data of the Wall Street Journal (WSJ) poll in order to analyze the characteristics of the expectation formation process for the yen/dollar exchange rate. Therefore, we apply the WSJ survey to shed light on two aspects of the expectation formation process. The first aspect refers to the question of how expectations are formed. The second aspect deals with the question whether the forecasters¹ can be regarded as homogenous.

The main advantage of the WSJ data set is that we can observe individual exchange rate expectations of a large number of forecasters and not only the mean or median of a group of forecasters. This feature allows us to analyze both the time series as well as the cross-sectional characteristics of the data set by applying panel econometric methods. The possibility to observe individual expectations distinguishes the WSJ data set from other data sets like the one compiled by Reuters and used by Leitner et al. (2003). Another advantage of the WSJ data set is that the poll has been conducted for about 20 years. By contrast, the study of Ito (1990) – who also operates with individual data – covers only the time period May 1985–June 1987. Hence, the time dimension in Ito (1990) is limited to a 2-year horizon. The data set of Ito (1990) is updated by Elliott and Ito (1999) and covers the period May 1985–May 1996. They find that the survey data are not the best predictor of future spot rates in terms of typical mean squared forecast error criteria. However, they also find that the survey data include information value in the sense that they can be used to generate profits.

The remainder of the paper is structured as follows. In the next section, we describe details of the WSJ data set. In Section 3, we examine the question whether expectations are formed rationally. In Section 4, we investigate the expectation formation process in more detail and compare it to the actual exchange rate process. Section 5 examines the relationship between the forecast accuracy and the expectation forming process while Section 6 concludes.

2. The WSJ data set

The WSJ regularly conducts a survey among financial market participants about their forecasts of several financial variables for a 6-month horizon. The survey is published biannually in the beginning of January and July. When the survey was launched in 1981, the focus was on the expected development of the Fed prime rate. Over time, the number of economic variables covered by the survey has increased considerably.² Since January 1989, the survey includes a 6-month forecast for the yen/dollar exchange rate. While the survey of the yen/dollar exchange rate was initially limited to 38 participants, it gradually increased to a maximum of 62 participants in January 1996 and has been very stable around 50 participants since 1997. Table 1 provides a summary of the main statistics of the data set for the period 1989–2007. It can be inferred that during the period under consideration forecasters expected on average a depreciation of the yen. While the average expectations are at the level of $\bar{E}[s_{t+1}] = 118.2$, the average exchange rate level was $\bar{s} = 117.5$. The log difference is equal to the value of 0.0058. The actual exchange rate process showed a downward trend and the dollar depreciated by about 0.29% each 6-months from a level of 125 yen/dollar in 1989 to a level of 112 yen/dollar in 2007.

The WSJ data set has already been used in some other studies. However, these other studies focus on questions that are different from the one in our analysis. For example, Greer (2003) examines the accuracy of the 1-year forecast of the 30 year US Treasury bond. The analysis concentrates on the question of whether economists are able to predict the direction of change correctly and finds some evidence that this is indeed the case. Cho and Hersch (1998) analyze whether the characteristics of forecasters

¹ The foreign exchange forecasters cannot be regarded as foreign exchange traders. However, they are frequently working as economists in commercial and investment banks, economic consultancies as well as universities. A complete list of the participants and their affiliation is available upon request.

² For example, since January 1985, survey participants have also been asked to forecast the GNP growth rate and since 1991 the GDP growth rate. Inflation and unemployment rates have been incorporated into the survey since 1989. Additionally, since 2002, the WSJ has published forecasts of the Federal Funds Rate.

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