NOMINAL AND REAL EXCHANGE RATE CO-MOVEMENTS

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This paper investigates the existence of common movements between nominal and real exchange rates across different countries in three regions – North America, Western Europe, and Central and Eastern Europe – by using the multi-factor model. It also examines the role of macroeconomic fundamentals (i.e., prices, money and output) in order to explain the variance of the exchange rate global factor. The findings suggest the existence of co-movements among exchange rates. The exchange rate global factor seems to play a central role in explaining exchange rate variability in Western Europe, whereas regional and country-specific factors are the most important ones in North America and Central and Eastern Europe, respectively. Finally, the paper shows empirical evidence in favour of the connection between exchange rate global factor variability and macroeconomic fundamentals. Moreover, the importance of fundamentals has increased in the recent global crisis.

JEL classification codes: E32, F44, F31
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I. Introduction

The literature on exchange rates has presented two main empirical regularities in recent decades. On the one hand, real exchange rates co-move closely with nominal exchange rates at short and medium horizons (see, for example, Burstein and Gopinath 2013), which implies that nominal shocks to the economy may have real effects. This first regularity, from a theoretical point of view, is commonly interpreted as an indication of price stickiness and would support the exchange rates models with sluggish price adjustment, such as the sticky-price monetary model (Dornbusch 1976). On the other hand, the relationship between exchange rates and other macroeconomic variables (underlying fundamentals) is weak. Thus, Meese and Rogoff (1983) show that the simple random walk model performs no worse than economic models in forecasting exchange rates at short to medium horizons. Baxter and Stockman (1989) show that flexible exchange rate regimes lead to sharp increases in nominal and real exchange rate volatility, although it has little effect on the distribution of fundamental macroeconomic aggregates. Flood and Rose (1995) come to similar conclusions. Obstfeld and Rogoff (2000) refer to the weak linkage between exchange rates and underlying fundamentals as the exchange rate disconnect puzzle.

The contribution of this paper is to extend the empirical work on these two regularities by using a different approach based on multi-factor analysis. We first examine the existence of co-movements between nominal and real exchange rates across North American countries (the United States and Canada), European Union countries (Austria, Belgium, Denmark, Finland, France, Germany, Italy, the Netherlands, Spain, Sweden and the United Kingdom) and Central and Eastern European countries (the Czech Republic, Hungary, Poland, Slovenia and Slovakia). Although the analysis of co-movements among macroeconomic variables has substantially grown in recent decades, there is no study that examines co-movements among nominal and real exchange rates across countries (see Section II). For this purpose, we use the multi-factor model, in the spirit of Kose, Otrok and Whiteman (2003, 2008) and Kose, Otrok and Prasad (2012). Moreover, we use effective exchange rate data because, from a macroeconomic point of view, the analysis of the effective exchange rates seems to be more appropriate than that of the simple market exchange rates. This is especially true for countries whose trade is diversified given that it considers the behaviour of the exchange rate of a country in relation to all its trading partners and allows one to assess the comparative
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