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# Investor reactions to news: a cognitive dissonance analysis of the euro–dollar exchange rate

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## Abstract

This paper investigates whether the depreciation of the euro vis-à-vis the US dollar exchange rate during 2000 can be attributed to asymmetric investor reactions to economic and political news, including central bank statements. Daily euro–dollar exchange rate changes from April 1, 2000 through September 22, 2000 are regressed on economic and political news about the US and the euro area. The results suggest an asymmetry in the investors' response to news, depending on whether it comes from the US or the euro area. Moreover, investors react differently to 'good' and 'bad' news, which suggests cognitive dissonance reduction.

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## 1. Introduction

The possible role of emotions in economic decision making has been recognised by both psychologists and economists. Thus, [Kahneman and Tversky \(1979\)](#) found that individuals exhibit behaviour that systematically violates expected utility theory. Over the past decade, the implications of their so-called prospect theory and of other psychological characteristics of individual decision making and information gathering for the behaviour of financial market participants have been studied both theoretically and empirically (see [Barberis and Thaler, 2002](#) for a survey article). This has resulted

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in explanations of anomalies like over-and underreactions of stock prices to news (Daniel et al., 1998), excessive trading by investors (Odean, 1998a,b) and the equity premium puzzle (Benartzi and Thaler, 1995).

More than two decades prior to the paper by Kahneman and Tversky (1979), Festinger (1957) developed the theory of cognitive dissonance, which states that individuals filter information in order to make it correspond to what they already believe. Over the past decades, his theory has been applied in economic theory. Akerlof and Dickens (1982) have used the concept of cognitive dissonance to explain behaviour in labour markets, whereas Goetzmann and Peles (1997) have used it in studying the behaviour of mutual fund investors. A related psychological phenomenon used in behavioural finance theory to explain underreactions of stock prices to news is conservatism (Edwards, 1968). In this paper, we study empirically whether information filtering due to cognitive dissonance might contribute to explaining the fall in the exchange rate of the euro vis-à-vis the US dollar in the 6 months preceding the first coordinated intervention in the exchange rate markets by the European Central Bank and others in September 2000. It has been argued, both by public authorities and in academic circles, that the depreciation of the euro vis-à-vis the dollar in the course of 2000 was difficult to explain on the basis of economic fundamentals only. Especially when the economic growth differential between the US and the euro area started to narrow in the second quarter of 2000, it was suggested by, for example, Welteke (2000), Wellink (2000) and De Grauwe (2000) that investor sentiments might account at least partly for the weakening of the euro (see Fig. 1 for the euro–dollar exchange rate since January 1, 1999; dollars per euro). The aim of the paper is to assess whether the data support this view. To this end, we study the daily response of the euro–dollar

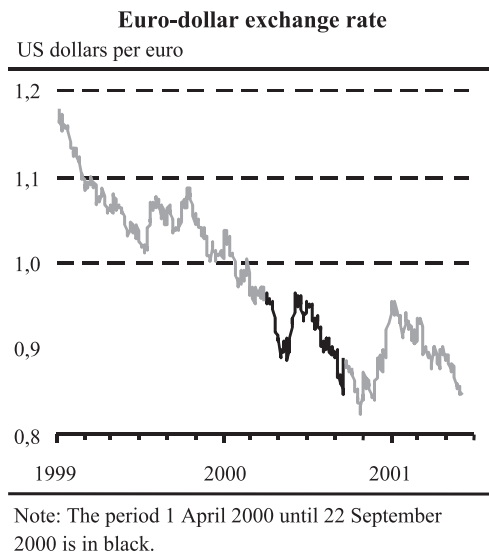


Fig. 1. Euro–dollar exchange rate.

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