Exchange rate expectations and economic policy uncertainty ☆

Joscha Beckmann [a,b], Robert Czudaj [c,d,*]

[a] Ruhr University of Bochum, Chair for International Economics, D-44801 Bochum, Germany
[b] Kiel Institute for the World Economy, Hindenburgufer 66, D-24105 Kiel, Germany
[c] University of Duisburg-Essen, Department of Economics, Chair for Econometrics, D-45117 Essen, Germany
[d] FOM Hochschule für Oekonomie & Management, University of Applied Sciences, Herkulesstr. 32, D-45127 Essen, Germany

ABSTRACT

This study provides a new angle on the relationship between political decisions and exchange rates. We link a conventional exchange rate modeling approach to the literature on the political economy of exchange rates and studies dealing with the role of policy announcements for financial market expectations by addressing the impact of policy uncertainty on exchange rate expectations and forecast errors of professionals. Our results show that expectations are not only affected by announcements but also by the degree of uncertainty regarding the future stance of economic policy. We find that forecast errors are strongly affected by policy uncertainty compared to expectations, suggesting that the effect of uncertainty is not efficiently accounted for in market expectations. Our main findings hold for economic policy uncertainty, fiscal policy uncertainty and monetary policy uncertainty. In addition, the estimates for the Japanese yen suggest a safe haven role of the yen since higher policy uncertainty in the US results in an expected appreciation of the yen.

© 2017 Elsevier B.V. All rights reserved.

1. Introduction

A key transmission channel for policymakers to achieve macroeconomic targets goes via an effect on expectations. The role of communication and transparency for financial market expectations is already well established (Neuenkirch, 2012). In the context of exchange rates, the role of announcements has recently been highlighted by the famous "whatever it takes" speech by Mario Draghi in July 2012 which resulted in an appreciation of the euro. Explaining exchange rate behavior still remains one of the most important areas in international economics. While a large amount of studies deals with realized exchange rates, the literature is notably silent on the determinants of exchange rate expectations. While this is partly due to limited data availability, aggregated expectation data has mostly been adopted rather as a predictor of future fundamentals than as a left-hand side variable although most exchange rate models correspond to expected exchange rates as the left-hand side variable, for example when analyzing the predictive power of aggregated survey data of exchange rate expectations.[1] Early studies by Blake et al. (1986) and Chinn

---

    [1] Most approaches for modeling expectations use disaggregated data on exchange rate expectations to explain characteristics of exchange rate markets, for example based on a distinction between chartists and fundamentalist with the latter taking changes in fundamentals into account. See Sarno and Taylor (2002) for an excellent overview of the large body of literature on exchange rates.

Table 1
Contributors to FX4casts consensus forecasts.

Allied Irish Bank, ANZ Bank, Bank of America/Merrill Lynch, Bank of New York Mellon, Barclays Capital, Bayerische Landesbank, BNP Paribas, Canadian Imperial Bank of Commerce, Credit-Agricola, Citigroup, Commerzbank, Credit Suisse - First Boston, Danske Bank, Deka, Deutsche Bank, DnBNOR, Economist Intelligence Unit, Goldman Sachs, Handels Banken, HSBC, IHS Global Insight, ING Bank, Intesa Sanpaolo, JP Morgan Chase, Julius Baer, Lloyds TSB, Macquarie Capital Securities, Moody's Economy.com, Morgan Stanley, National Australia Bank, Nomura, Nordea, Rabobank, Royal Bank of Canada, Royal Bank of Scotland, Scotia Bank, SEB, Societe Generale, Standard Chartered, Suntrust, Swedbank, Tokyo-Mitsubishi UFJ, Toronto Dominion, UBS Warburg, UniCreditHVB, Vontobel, Wachovia, Westpac.

Table 2
Full list of terms for the monetary and fiscal policy uncertainty index.

Monetary policy	Federal Reserve, the fed, money supply, open market operations, quantitative easing, monetary policy, fed funds rate, overnight lending rate, Bernanke, Volker, Greenspan, central bank, interest rates, fed chairman, fed chair, lender of last resort, discount window, European Central Bank, ECB, Bank of England, Bank of Japan, BOJ, Bank of China, Bundesbank, Bank of France, Bank of Italy
Fiscal policy	Government spending, federal budget, budget battle, balanced budget, defense spending, military spending, entitlement spending, fiscal stimulus, budget deficit, federal debt, national debt, Gramm-Rudman, debt ceiling, fiscal footing, government deficits, balance the budget

and Frankel (1994) find little predictive power of exchange rate expectations for future exchange rates. Despite some more encouraging results, this finding has not been systematically overturned (see, e.g., Cavusoglu and Neveu, 2015; Verschoor and Wolff, 2002).

Exchange rate expectations reflect all available information in case of market efficiency. Such information is mostly approximated by the current set of macroeconomic fundamentals. However, although both expected value models of exchange rates and the so-called news approach to modeling exchange rates postulates the importance of macroeconomic news for exchange rates, the role of macroeconomic policy uncertainty has not been empirically considered. Once again, the most common proxy for news corresponds to unexpected changes in fundamentals. However, a key component of both the current set of information and macroeconomic news corresponds to expectations related to macroeconomic policy.

Against this background, this study contributes to the literature by analyzing the impact of different policy uncertainty dimensions on exchange rate expectations. In a nutshell, we focus on three questions: We start by asking whether policy uncertainty affects exchange rate expectations and/or exchange rates forecast errors. If such effects are identified, we turn to the question whether they occur over the short, medium or over the long-run. We also focus on the direction of such effects, that is, whether increasing uncertainty leads to an expected depreciation or appreciation of the US dollar and higher (or lower) forecast errors, respectively. Finally, we formally test for Granger causalities between policy uncertainty and expectations as well as forecast errors.

By analyzing these questions, we connect two strands of the literature: The already outlined conventional exchange rate modeling approach based on expected macroeconomic fundamentals and macroeconomic news and the literature which focuses on the political economy of exchange rates in the spirit of political business cycles and the role of macroeconomic announcements for expectations on financial markets. Based on a distinction between monetary policy uncertainty, fiscal policy uncertainty and overall economic policy uncertainty according to news in the US, we systematically evaluate the impact of policy uncertainty on exchange rate expectations and forecast errors over different horizons. Considering that several uncertainty measures and underlying definitions exist, it is important to emphasize that we do not rely on unexpected volatility measures in the spirit of (Jurado et al., 2015) but instead we apply newspaper coverage based measures related to different kinds of policy uncertainty.[2] Such a measure is more capable of capturing expectations about economic policy.

A major advantage of our policy uncertainty measure is the availability of continuous data. The literature on political business cycles adopts either data on elections (when considering opportunistic cycles) or political orientation (when considering partisan cycles) when analyzing an impact of politics on exchange rates or exchange rate regimes (Berdiev et al., 2012). However, both measures are usually constant for several years and can only be analyzed on an annual basis. Hence, they can solely be considered for explaining changes in exchange rate regimes while they cannot be applied for examining exchange rate expectations or forecast errors on a monthly frequency. Against this background, the monthly measure we consider enables us to analyze the impact of politics on exchange rates from a novel perspective. When it comes to exchange rate expectations, we rely on consensus forecasts which are considered to be the most adequate approximation of market expectations available. Recent studies dealing with comparable datasets in a different context are for example provided by Fratzscher et al. (2015), Bacchetta et al. (2009), and Cavusoglu and Neveu (2015).

---

[2] See also Bloom (2014) for an additional uncertainty measure which is defined as expected variance.