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Yu-Hsi Chou*

Abstract

In this paper, we apply the monetary model to examine the degree to which economic fundamentals can explain large and persistent fluctuations in the spread between the nominal exchange rate and monetary fundamentals i.e. the so-called “exchange rate disconnect puzzle.” We show that deviations from purchasing power parity account for the bulk of the variation in the deviations of the nominal exchange rate from observed monetary fundamentals, whereas the importance of the risk premium becomes more pronounced after the establishment of the European Economic and Monetary Union.

Keywords: monetary fundamentals, exchange rate disconnect puzzle, variance decomposition

JEL Classification: C5, F31, F47.

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