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Exchange rate forecasts and expected fundamentals[☆]



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ABSTRACT

Using a large panel of individual professionals' forecasts, this paper demonstrates that good exchange rate forecasts are related to a proper understanding of fundamentals, specifically good interest rate forecasts. This relationship is robust to individual fixed effects and further controls. Reassuringly, the relationship is stronger during phases when the impact from fundamentals is more obvious, e.g., when exchange rates substantially deviate from their PPP values. Finally, forecasters largely agree that an interest rate increase relates to a currency appreciation, but only good forecasters get expected interest rates right.

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1. Introduction

Exchange rates are among the most important prices in open economies. In contrast, however, to their importance for firms, investors, and policy-makers, there is a considerable lack of understanding on the underlying determinants of exchange rates. At intermediate horizons, such as a month or half a year ahead, exchange rates seem to be hardly explained at all and, in particular, seem to be disconnected from fundamentals (Obstfeld and Rogoff, 2000; Engel, 2014). This disconnect is surprising, given the fact that foreign exchange markets react to changes in economic fundamentals within minutes (Andersen et al., 2003) and that exchange rates reflect long-term changes in purchasing power (Taylor and Taylor, 2004). At intermediate horizons, however, the relationship between fundamentals and exchange rates seems to be largely unobservable (Frankel and Rose, 1995; Rogoff, 2007; Rossi, 2013). In this paper we suggest a new approach to uncovering potential connections, and provide evidence that fundamentals may indeed shape exchange rates.

Our motivation rests on the notion that the relationship between exchange rates and fundamentals is quite complex, for several reasons. First, the asset market approach to exchange rates emphasizes that *expected* fundamentals can have a greater impact on today's exchange rates than actual observed fundamentals, as emphasized by, for example, Engel and West (2005). Second, it is known that market participants possess and use fundamentals in heterogeneous ways (see Ito, 1990; MacDonald and Marsh, 1996), and that the use of fundamentals may change over time (e.g. Sarno and Valente, 2009). Finally, market participants do not only use fundamentals but also non-fundamentals as information in their decision making (Menkhoff and Taylor, 2007). Each of these sources of complexity may explain why conventional tests of exchange rate models in the spirit of Meese and Rogoff (1983) – regressing exchange rate changes on changes in fundamentals – fail (Cheung et al., 2005): the reason is not necessarily the above mentioned “disconnect” but possibly the use of a “false” model, i.e. a model that cannot account well enough for existing complex relations.

In order to circumvent this problem, we propose a research strategy which aims at making potential links between exchange rates and fundamentals visible without requiring a specific exchange rate model: the basic idea is to examine whether there is a positive relationship between good exchange rate forecasting and good forecasting of exchange rate fundamentals by the *same individual*. This approach relies on survey data, i.e. on *expected* rather than *realized* data. Moreover, we do not make structural assumptions on forecasting *behavior*, but consider forecasting *performance* as an objective criterion. The reliance on performance requires no information on how (time-varying) fundamentals are used.

For our sample of more than 1050 Germany-based professionals, we find that good US Dollar–Euro forecasters also make good interest rate forecasts for the U.S. and the Euro area. Thus we confirm the link between interest rates and exchange rates which is expressed in exchange rate models and by foreign exchange traders (Cheung and Chinn, 2001). This contemporaneous link is shown here for the first time in individual expectation data. In three more examinations we elaborate this link, suggesting that information about fundamentals is systematically linked to good exchange rate forecasts.

As a first examination we exploit the available panel approach by estimating individual fixed effects. These effects take account of unobserved heterogeneity between professional forecasters and thus control for a general ability to make good forecasts. We find that beyond individual differences in forecasting performance, our relationship of interest remains valid. Next we find that our main result is robust to the consideration of more fundamentals and year-specific effects. Finally, it tentatively holds for additional available currencies. All this does not prove a causal impact from interest rates expectations on exchange rate forecasts but it shows a strong relation between understanding fundamentals and exchange rates; and this relation is not driven by individual ability, certain years or a single exchange rate.

Second, we test an implication of our main result: if good interest rate forecasts go along with good exchange rate forecasts, this relationship will be stronger when the impact of fundamentals on exchange rates is more obvious. The relationship between fundamentals and exchange rates may be closer if there is a consensus about the impact of fundamentals, for example, when exchange rates deviate more strongly from their PPP value. Our evidence supports this time-varying relation.

Third, we test our relationship of interest by applying it to a simple mechanism of exchange rate determination. This mechanism picks up a standard relationship of international macro policy: a

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