DESCRIPTION FOR THE GENERAL PUBLIC

Understanding the relationship between macroeconomic fundamentals and exchange rates as well as the ability to predict their future movements are important to many economic agents. For policy-makers the key issue is that fluctuations in exchange rates exert a large impact on the economy. For that reason, central institutions analyze the dynamics of exchange rates while taking decisions on economic policy, but also while managing their FX assets and liabilities. For investors, an important issue is that foreign assets often constitute a large part of their portfolios. The ability to predict FX movements can be therefore exploited to construct profitable trading strategies. Ultimately, for exporters and importers exchange rate fluctuations constitute one of the most important risk factors for their activity.

The reference benchmark in exchange rate forecasting is a simple no-change forecast, assuming that the future price will stay at the current level. It turns out that constructing econometric or economic models that can consistently outperform the no-change forecast is a real challenge. In the project we will address this issue by conducting a comprehensive analysis on the predictive content of equilibrium exchange rate (EER) models. The usefulness of EER models, which assume that there is a long-run relationship between exchange rates and macroeconomic fundamentals, will be tested using three approaches. First, we will focus on the accuracy of exchange rate forecasts that are based on EER models. Second, we will evaluate the characteristics of FX trading strategies based on EER models. Third, we will use the cross-sectional perspective to explore if EER misalignments are leading indicators for macroeconomic variables.

The results of the project should help in understanding the relationship between exchange rates and macroeconomic fundamentals, hence can be used in economic policy making. On top of that, we plan to present methods helpful in exchange rate forecasting, which could contribute to better management of FX risk.