

The Economics of Exchange Rates

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The purpose of this course is to overview the literature in 5 key areas of the Economics of Exchange Rates. The areas are: Exchange rate regimes issues; purchasing power parity and the PPP puzzle; nominal exchange modelling; real exchange rate modelling; the new open economy macroeconomics and exchange rate behaviour; the economics of fixed exchange rates – speculative attack models and the target zone literature. I take an approach which is supportive of a macro-based-fundamentals view of the exchange rate determination process.

The principle text for the course will be the *Economics of Exchange Rates: Theories and Evidence* (second edition), by R MacDonald, forthcoming 2006, Taylor and Francis.

Detailed readings will provided during the course for each topic.

Topic 1. Introduction and Exchange Rate Regime Issues.

In this topic we will overview some basic exchange rate concepts and present some of the key stylised facts in the economics of exchange rate literature. This topic will also contain an overview of exchange rate regime issues such as the fixed versus floating exchange rate debate and the recent literature on the categorisation of exchange rate regimes.

Reading: Chapters 1 and 2 of MacDonald (2006)

Topic 2. Purchasing Power Parity and the PPP Puzzle.

This topic contains a discussion of the PPP puzzle and its potential resolution in terms of econometric and economic fixes, such as pricing to market, productivity effects and costs of adjustment. Recent work, which tries to use new trade theory models to understand the PPP puzzle, will be highlighted.

Reading: Chapters 3 and 4 of MacDonald (2006)

Topic 3. Nominal exchange rate modelling.

Here we consider the monetary class of models to address the exchange rate disconnect of Obstfeld and Rogoff (2000). The disconnect has two aspects relating to the issue of exchange rate volatility (both intra and inter regime volatility) and the apparent failure of exchange rate models to perform better than a random walk in an out-of-sample forecasting context.

Reading: Chapters 5 to 7 of MacDonald (2006)

Topic 4. Real Exchange Rate Modelling.

In this topic we consider a group of issues which are related through their focus on the behaviour of the real exchange rate. More specifically, we consider such issues as: measuring empirically an equilibrium exchange rate, using BEERs, FEERs and the NATREX; the empirical evidence on the real interest rate real exchange rate relationship; decomposing real exchange rates using structural VARs.

Reading: Chapters 8 and 9 of MacDonald (2006)

Topic 5. The New Open economy Macroeconomics and Exchange Rate Behaviour.

In this topic the basic two country Redux model is set out and the exchange rate behaviour in this and the small country variant outlined. Recent variants of the NOEM model are considered, particularly stochastic versions which have important explanations for exchange rate volatility.

Reading: Chapters 10 and 11 of MacDonald (2006)

Topic 6. The Economics of Fixed Exchange Rates.

This topic overviews both the theoretical and empirical aspects of both target zone and speculative attack models.

Reading: Chapters 13 and 14 of MacDonald (2006)