Exchange Rates and Fundamentals:
Closing a Two-country Model

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Current Draft: January 19, 2014

Abstract

In an influential paper, Engel and West (2005) claim that the near random-walk behavior of nominal exchange rates is an equilibrium outcome of a variant of present-value models when economic fundamentals follow exogenous first-order integrated processes and the discount factor approaches one. Subsequent empirical studies further confirm this proposition by estimating a discount factor that is close to one under distinct identification schemes. In this paper, I argue that the unit market discount factor implies the counterfactual joint equilibrium dynamics of random-walk exchange rates and economic fundamentals within a canonical, two-country, incomplete market model. Bayesian posterior simulation exercises of a two-country model based on post-Bretton Woods data from Canada and the United States reveal difficulties in reconciling the equilibrium random-walk proposition within the two-country model; in particular, the market discount factor is identified as being much lower than one.

Key Words: Exchange rates; Present-value model; Economic fundamentals; Random walk; Two-country model; Incomplete markets; Cointegrated TFPs; Debt elastic risk premium.

JEL Classification Number: E31, E37, and F41

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‡ I would like to thank Kosuke Aoki, Martin Berka, Hiroshi Fujiki, Shin-ichi Fukuda, Ichiro Fukunaga, Shinsuke Ikeda, Kazuko Kano, Kiminori Matsuyama, Toshi Mukoyama, Junko Koeda, Takushi Kurozumi, Jim Nason, Yoshiyasu Ono, Makoto Saito, Etsuro Shioji, Christoph Thoenissen, and seminar participants at Hitotsubashi University, the Institute for Monetary and Economic Studies at the Bank of Japan, the Institute of Social and Economic Research at Osaka University, the University of Tokyo, Victoria University of Wellington, and the 2013 Summer Workshop on Economic Theory at Hokkaido University for their discussions and useful suggestions. Hiroshi Morita provides an excellent research assistance. I wish to thank the Scimeikai foundation and a grant-in-aid for scientific research from the Japan Society for the Promotion of Science (number 24330060) for their financial support. I am solely responsible for any errors and misinterpretations in this paper. The views in this paper are those of the author and are not those of the Bank of Japan.