

Modeling and Predictability of Exchange Rate Changes by Extended Relative Nelson-Siegel Class of Models

April 15, 2018

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Abstract

We investigate the predictability of exchange rate changes by extracting the factors from the three-, four-, and five-factor model of the relative Nelson-Siegel class. Our empirical analysis show that the relative spread factors are important to predict the future exchange rate changes and the relative level factor has explanatory power for predicting the excess currency return. The regression model based on the factors of five-factor model is superior to the three- and four-factor model. Moreover, the predictability of the exchange rate changes in sample fit is statistically significant.

Key words: predictability, exchange rate, uncovered interest rate parity, yield curve model

JEL Classification: E47; F31; G17