

A dynamic econometric analysis of the dollar-pound exchange rate in an era of structural breaks and policy regime shifts

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Abstract

We employ a newly-developed partial cointegration system allowing for level shifts to examine whether economic fundamentals form the long-run determinants of the dollar-pound exchange rate over a recent period characterised by structural breaks and policy regime shifts. The paper uncovers a class of local data generation mechanisms underlying long-run and short-run dynamic features of the exchange rate using a set of economic variables that explicitly reflect quantitative monetary policy and the influence of a forward exchange market. The impact of the Brexit referendum is evaluated by examining forecasts when the dollar-pound exchange rate fell substantially around the vote.

Keywords: Exchange rates, Unconventional monetary policies, Structural breaks, Economic fundamentals, General-to-specific approach, Partial cointegrated vector autoregressive models

JEL classification codes: C22, C32, C52, F31.

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