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A Consumption-Based Approach to Exchange Rate Predictability

Working Paper No. 857 Keep in mind
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This paper provides evidence of short-run predictability for the real exchange rate by performing out-of-sample tests of a forecasting equation which is derived from a consumption-based asset pricing model. In this model, the real exchange rate is predictable as a result of the implications of preferences with habit persistence on the pricing of international assets. The implied predictors are: domestic, US and world consumption growth. Empirical exercises show evidence of short-term predictability on the bilateral rates of 15 out of 17 countries vis-à-vis the US over the post Bretton-Woods float. A GMM estimation of the parameters of the model also finds evidence of the presence of habits in consumers' preferences.

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Fuente: https://www.banrep.gov.co/en/borrador-857