

A Multiple-Horizon Search for the Role of Trade and Financial Factors in Bilateral Real Exchange Rate Volatility

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Summary

The real exchange rate (RER) is a key relative price variable for macroeconomic adjustment in an open economy. A longstanding issue in international monetary economics is what determines real exchange rate (RER) variability. Volatile RER fluctuations are often attributed to significant monetary disturbances operating under nominal rigidities. However, traditional monetary models of exchange rates do not fare too well with the modern float data. Building on a pricing-to-market paradigm, new open economy macroeconomics models have gained popularity for explaining RER dynamics. In addition to such non-monetary factors as government spending and productivity growth, trade activity plays an important role in explaining RER volatility. Greater trade flows may provide a channel that facilitates faster aggregate price adjustment to economic shocks. Changes in exchange rates are shown to depend not only on the size of economic shocks but also on the size of the tradables sector. For given volatilities of economic shocks, RER volatility would decrease with openness to trade.

This study investigates the sources of bilateral RER volatility in industrial countries. Going beyond traditional macroeconomic determinants, we identify the role of both trade- and finance-related factors in explaining RER volatility at different time horizons. The results suggest that RER volatility tends to increase with financial openness and with transport costs but decrease with trade openness and with financial depth. Moreover, the time horizon matters. Financial factors (financial openness and financial depth) are found to influence RER volatility at primarily short horizons, while trade-related factors (trade openness and transport costs) contribute significantly also to RER volatility at much longer horizons. The relative importance of traditional macroeconomic fundamentals and these trade- and finance-related factors can vary considerably across horizons.