What Does the Yield Curve Tell Us about Exchange Rate Predictability?

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Summary

This paper uses information contained in the cross-country yield curves to test the asset-pricing approach to exchange rate determination, which models the nominal exchange rate as the discounted present value of its expected future fundamentals. Since the term structure of interest rates embodies information about future economic activity such as GDP growth and inflation, we extract the Nelson-Siegel (1987) factors of *relative* level, slope, and curvature from cross-country yield differences to proxy expected movements in future exchange rate fundamentals. Using monthly data between 1985-2005 for the United Kingdom, Canada, Japan and the US, we show that the yield curve factors predict bilateral exchange rate movements and excess currency returns one month to two years ahead. They also outperform the random walk in forecasting short-term exchange rate returns out of sample. Our findings have intuitive economic interpretations and offer an explanation to the uncovered interest parity puzzle.