Combining Economic Fundamentals to Predict Exchange Rates

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ABSTRACT

This research utilizes statistical and economic methods to evaluate exchange rate predictability out-of-sample. The forecast performance of five widely used empirical models that predict nine one-month ahead exchange rates quoted in U.S. dollars is evaluated using these statistical and economic methods. The ex ante forecasts of the empirical models are also combined using model averaging techniques so as to eliminate issues of model uncertainty. Designing a portfolio that uses a dynamic asset allocation strategy that relies on a model's one-step ahead forecasts assesses the economic gains. The analysis finds that statistically and economically the empirical models used for rolling out-of-sample forecasting do not outperform the benchmark random walk model in predicting the different exchange rates, and the combination models are not anymore successful. When recursive estimation is used, the Taylor Rule and most forecast combination models outperform the random walk model in predicting most exchange rates using the statistical methods. PPP, the Taylor Rule, and some of the combination forecasts outperform the random walk model economically.