Forecasting Daily Exchange Rates with Stock Return Differential

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1. What is the question (of the paper)?

Whether the exchange-rate can be predicted or not. This paper tests the exchange-rate forecastability of uncovered equity parity (UEP) by Taiwan’s daily data.

2. Why should we care about it?

Since economists usually have no much luck in exchange rate forecasting, finding an appropriate method could help economists to forecast future exchange rate.

3. What is your (or the author’s) answer?

This paper finds that the domestic currency will depreciate on the next trading day when domestic stock market outperformed foreign (the U.S.) market, which suggest that the UEP condition holds. The stock return differential has strong in-sample and out-of sample predictive ability in 5 of the 6 most-traded currencies (and 3 of 4 Asian currencies in the robustness check). Our empirical evidence implies that daily exchange rate are not random walks. Furthermore, it is predictable.

4. How did you (or the author’s) get there?

By using the daily data of Taiwan to evaluate In-Sample Predictive Regression Models and Out-of-Sample Forecasts. The two models separately are:

\[
\text{In-Sample: } s_{t+1} - s_t = \alpha + \beta x_t + u_{t+1}
\]

\[
\text{Out-of-Sample: } s_{t+1} - s_t = \alpha + \beta x_t + u_{t+h},
\]

the h-step-ahead pseudo out-of sample forecast of the daily exchange rate is obtained by:

\[
\hat{s}_{t+h} = s_t + \bar{\alpha}_t + \bar{\beta}_t^h x_t, t = R, R+1, ..., T-h
\]