Introduction

Since its inception on 1 January 1999, the euro, as measured against the US dollar, has experienced a period of sustained weakness followed by a period of sustained strength. After weakening slightly since the beginning of 2005, the euro is currently hovering around its initial value. Conventional models of exchange-rate behaviour (see Isard, 1995) rely on underlying economic fundamentals to explain exchange-rate paths. However, as De Grauwe (2000) discusses, these models do not provide clear guidance for an analysis of the factors driving the fluctuations in the euro, as speculative market activity or other noise can dominate the role of fundamentals in the short term. The movements of the euro/dollar exchange rate are not easily explained, as it is difficult to disentangle the roles of economic fundamentals and ‘news’ from ‘pure noise’ (a random walk).

Studies of real exchange-rate movements encounter similar difficulties.1 Lane and Milesi Ferretti (2004) suggest that it is possible to draw some conclusions on real exchange rates using measures of a country’s net external position. In this chapter, we draw upon the ideas set out in Lane and Milesi Ferretti (2004), as well as in Cavallo and Ghironi (2002) and Obstfeld and Rogoff (1995), which find that a country’s net foreign asset position provides information that relates to the value of the home currency. We investigate if this information can be exploited in a systematic way. As our study is concerned with the nominal exchange rate rather than the real exchange rate we do not need to constrain ourselves to the analysis of fundamentals. We also consider the roles of factors that affect nominal developments.

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Many explanations for the initial and sustained decline of the euro have been advanced in the literature, including those relating to structural weaknesses in the euro area, uncertainty over the correct equilibrium value of the euro (both in De Grauwe, 2000), market uncertainty over the future course of ECB policy, and productivity gains and hence stronger profitability and growth in the US (Corsetti and Pesenti, 1999). Meredith (2001) draws upon this latter view and attributes much of the initial weakness in the euro to a strengthening dollar, which came on the heels of a surge in equity market capitalisation in the US starting in the mid-1990s. In line with the evidence of strong wealth channels in US consumption (as found in Al-Eyd, Barrell and Holland, 2006), this stockmarket dynamic gave rise to a large positive demand shock and this contributed to the strength of the dollar. Brooks et al. (2001) also find evidence supporting a portfolio-based view over this period where net flows from the euro area into US stocks closely track movements in the euro/dollar exchange rate.

Since 2001, there has been a reversal of FDI and equity flows between the US and the euro area and a subsequent strengthening of the euro. This study seeks to shed some empirical light on the movements of the euro by adopting a portfolio-based approach. Our framework is couched within the familiar uncovered interest parity (UIP) relation where the implied excess on the bilateral exchange rate (part of which can be described as a risk premium related to portfolio composition) relates to characteristics of both the host and home country. It is argued that the US-based component of the premium is the same regardless of the geographic location of the external portfolio manager, but that this specific location will have different effects on the overall premium. As such, we define a closed portfolio bloc – consisting of the US, the UK and the euro area – and simultaneously estimate a set of bilateral risk premium adjusted arbitrage equations and examine the properties of the unexplained (or random) components for stationarity. In addition, we investigate the possibility that this random component may be the result of ‘news’ that becomes available subsequent to the time at which the exchange rate is set. Specifically, we derive estimates of ‘news’ based upon innovations in monetary policy – as encapsulated in the changes in the term structure of interest rates – and on the implications of changes in fiscal policy – as encapsulated in historical NIESR forecasts – to explain a substantial portion of this random component of the excess on the estimated US/euro area arbitrage equation. As a result, we are able to decompose the component not explained by the arbitrage condition into both systematic and pure random components.

Understanding the reasons for movements in exchange rates is very important for policy makers since it is possible that a fall in the euro could lead to an increase in inflationary pressure, and hence require a monetary response from the Central Bank. However, as Al-Eyd, Barrell and Pomerantz (2005) argue, the effects of a movement in a bilateral exchange rate will