THE PERILS OF FORECASTING EXCHANGE RATES

If exchange rates are asset prices that respond immediately to changes in expectations and interest rates, they should have properties similar to those of other asset prices, for example, stock prices. Like stock prices, exchange rates should respond strongly to "news," that is, to unexpected economic and political events; and, like stock prices, they therefore should be very hard to forecast.

Despite the notorious difficulty of forecasting stock prices, there is no shortage of newsletters and television programs devoted to stock-market prediction. Similarly, numerous firms sell exchange-rate forecasts to individual investors, international corporations, and others with financial interests in the foreign-exchange market. In a well-known study, Richard M. Levich of New York University surveyed the track record of a dozen exchange-rate forecasting companies in making near-term guesses as to future rates.*

The results were depressing for would-be exchange-rate oracles but encouraging for the asset approach to exchange rates. Levich found little evidence over his sample period that professional forecasters do systematically better than an individual who, for example, uses the three-month forward exchange rate as her forecast of the spot rate that will materialize in three months.† This finding does not mean that forward rates are accurate predictors; on the contrary, the evidence suggests that forward rates usually contain little information useful in predicting future spot rates (as we shall see in Chapter 21). What Levich's results do show is that inherently unpredictable "news" plays such a dominant role in determining exchange rates that exchange-rate movements, like movements in stock prices, are almost completely impossible to forecast over horizons of a year or less.

The theory we developed in this chapter suggests that exchange rates should not be completely impossible to forecast. According to the interest parity condition, interest-rate differentials should give an indication of how much currency depreciation to expect. In practice, however, *unexpected* or surprise currency movements are much greater than interest-rate differences and swamp the predictable movements in exchange rates. Forecasts based on economic models seem to be most successful when used for long-run predictions, that is, predictions of exchange rates years ahead. For example, a country with sustained increases in its price level is likely eventually to experience currency depreciation, although the precise timing of the depreciation may be impossible to predict. In the next few chapters we will develop an open-economy model that links exchange rate movements to changes in countries' price levels and other macroeconomic variables.

*See "Evaluating the Performance of the Forecasters," in Donald R. Lessard, ed., *International Financial Management: Theory and Application*, 2nd ed. New York: John Wiley & Sons, 1985, pp. 218–233. For updated discussions of forecasting exchange rates see Christian Dunis and Michael Feeny, eds., *Exchange Rate Forecasting*, Chicago, Probus Publishing Co., 1989; and the book by Levich in this chapter's Further Reading.

†This chapter's appendix suggests one reason for thinking that forward exchange rates might be related to expected future spot rates.