

The Common Trend and Transitory Dynamics In Real Exchange Rate Fluctuations

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This study explores the sources of real exchange rate fluctuations under the current float. Using a cointegration model of the real exchange rate, the innovations are decomposed into transitory and common{trend components. Both transitory and common{trend innovations are found to explain an appreciable portion of real exchange rate fluctuations, albeit their relative importance can vary across major currencies. Further analysis suggests that common{trend innovations are attributable to both productivity and monetary changes, albeit transitory innovations are linked primarily to monetary changes. The empirical results are largely consistent with an open{economy macroeconomic model.

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Words: 7199

Covariance's Matrix,