Third-Currency Effects in a Tri-Polar Model of Foreign Exchange

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We look into the possible contribution of third currency effects to exchange rate modeling in this paper. We reopen the subject of currency substitution and examine whether the third currency effects change when the third currency is a complement as oppose to when it is a substitute for currencies appearing in a bilateral exchange rate quote. The analysis and hypotheses tests are carried out within a simple macro-econometric model with one common permanent component driving the system of bilateral exchange rates for the US dollar, the Japanese yen and the euro. We find an evidence of currency complementarity between the yen and the euro and currency substitution of the dollar for both the euro and the yen. Moreover, the third currency effects exhibit a pattern consistent with our findings on the degree of complementarity and substitution among the three currencies.

Keywords: Exchange Rates Modeling, Currency Substitution, Third Currency Effects

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