

Chapter 24 The Monetary Approach

Question 24.4

Locate the St. Louis Fed working paper “How well do monetary models forecast exchange rates?” by Neely and Sarno on the web. The paper is technical (particularly section 3) but it is not important to study or understand the econometrics here. It does give you an insight into the heavy econometric requirements of empirical exchange rate research.

24.4A What general assumptions lie behind the monetary model according to the paper?

24.4B Does the monetary model forecast exchange rates well? Why (not)?

24.4C How can you reconcile the evidence of figure 24.8 and 24.9 with the forecasting track record of the monetary model?

Question 24.5

For answering the question below, you can use the [question 24-5 simulation file](#) on the website. It is a simulation of the monetary approach as in figure 24.4. Suppose the domestic economy we want to analyse is China. Foreign is the rest of the world.

24.5A Does China currently have a current account surplus in this simulation? Explain.

24.5B What happens to prices if we go to a long term equilibrium? Explain

24.5C Which factors influence the long run price level? Explain.

Reset the simulation to the initial situation. China is facing pressure from other countries to revalue its exchange rate. They blame China for exporting deflation.

24.5D How does China’s response affect the long term equilibrium of domestic and foreign prices?

Question 24.6

The [Excel file 24-6](#) contains data on exchange rates, the money stock M3 and GDP, for five countries including the US. There are two data points, 1980 and 2005. See if you can test the monetary model graphically for these countries, analogous to figure 24.8 and 24.9. Please note that lowercase letters in the textbook represent logs.