Contents

List of Tables ix

List of Figures x

Notes on the Contributors xi

Introduction 1

Part I The Purchasing Power Parity and its Implications for Equilibrium Exchanges Rates

1 Three Exchange Rate Puzzles: Fact or Fiction? 9
Ronald MacDonald

1.1 Introduction 9
1.2 The PPP puzzle 10
1.2.1 Testing PPP 14
1.2.2 Econometric explanations for the PPP puzzle 23
1.3 The volatility puzzle 32
1.3.1 The forward-looking monetary relationship and the magnification effect 33
1.3.2 Empirical evidence on inter- and intra-regime volatility 44
1.4 The levels puzzle and out-of-sample forecasting 46
1.5 Summary and conclusions 53

2 The Real Exchange Rate Misalignment in the Five Central European Countries – Single Equation Approach 61
Jan Frait, Luboš Komárek and Martin Melecký

2.1 Introduction 61
2.2 Development and determinants of the real exchange rates 63
2.2.1 The real exchange rate developments in the new EU Member States 63

2.2.2 The fundamental factors affecting the real exchange rate 67
2.3 The equilibrium real exchange rate concepts 68
2.3.1 Methods based on an economic theory 69
2.3.2 Outline of the behavioural model for EU5 countries 70
2.4 Empirical evaluation and evidence for the EU5 countries 72
2.4.1 Empirical techniques 72
2.4.2 Misalignments of the EU5 countries' currencies 78
2.5 Conclusion 81

3 Real Equilibrium Exchange Rate in China. Is the Renminbi Undervalued? 94
Virginie Coudert and Cécile Couharde

3.1 Introduction 94
3.2 Is the renminbi undervalued? The 'usual suspects' 95
3.3 Estimating the Balassa effect 98
3.3.1 The Balassa effect 98
3.3.2 Cross-section estimations 100
3.3.3 Panel data estimations 103
3.4 Discussion 107
3.4.1 Why is there no Balassa effect at work in China? 107
3.4.2 Comparisons with previous results 108
3.5 Conclusion 110

Part II Exchange Rates Dynamics and Pass-Through Effects

4 Exchange Rate Pass-Through Effect and Monetary Policy in Russia 115
Victoria V. Dobrynskaya and Dmitry V. Levando

4.1 Introduction 115
4.2 Literature review 118
4.2.1 Theories of exchange rate PTE 118
4.2.2 Empirical evidence 119
4.2.3 Influence of monetary policy on PTE 121

4.3 Theoretical model 121
4.4 Empirical analysis 123
4.4.1 Data 123
4.4.2 Methodology and results 125
4.2.3 Influence of monetary policy on PTE 132
4.5 Conclusion 135

5 Disaggregated Econometric Models to Forecast Inflation in Hungary 139
Viktor Várpalotai

5.1 Introduction 139
5.2 Inflation forecasting models used by the MNB 140
5.3 The disaggregated cost pass-through based inflation forecasting model 142
5.3.1 Framework of the model 142
5.3.2 Econometric issues: Distributed lag estimator derived from smoothness priors 149
5.4 Empirical results and the predictive accuracy of the model 150
5.5 Conclusions 153

Part III Exchange Rates Dynamics and Structural Shocks on Economies

6 An Open Economy Dynamic General Equilibrium Model Linking the Euro Area and the US Economy 169
Gregory de Walque and Raf Wouters

6.1 Introduction 169
6.2 Model description 172
6.2.1 Households 172
6.2.2 The firms and price setting 176
6.2.3 Balance of payments 182
6.2.4 Market equilibrium 182
6.2.5 The *US* economy and the rest of the world 183
6.2.6 The monetary policy 184
6.2.7 Structural shocks summary 184
6.3 Data and estimation 185
6.4 Impulse response functions for the shocks 191
6.4.1 Productivity shocks 191

	6.4.2	Domestic demand shocks	201
	6.4.3	Monetary policy shocks	201
	6.4.4	Oil shocks	204
	6.4.5	Uncovered interest rate parity shock to the exchange rate	209
	6.4.6	ROW shocks	209
6.5		Model validation by summary statistics	210
6.6		The unconditional variance decomposition of the forecast errors	214
6.7		Conclusion	223
7		Liberalisation Shocks and Real Exchange Rates Appreciation in the Transition Economies *Christos Papazoglou*	227
7.1		Introduction	227
7.2		The model	229
7.3		The general solution of the system	233
7.4		Increase in core inflation	235
7.5		Decrease in the demand for money	237
7.6		Conclusions	239
Index			243