Co-movements in real effective exchange rates: evidence from the dynamic hierarchical factor model

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We analyze and quantify co-movements in real effective exchange rates while considering the regional location of countries. More specifically, using the dynamic hierarchical factor model (Moench et al. (2011)), we decompose exchange rate movements into several latent components: worldwide and two regional factors as well as country-specific elements. Then, we provide evidence that the worldwide common factor is closely related to monetary policies in large advanced countries while regional common factors tend to be captured by those in the rest of the countries in a region. However, a substantial proportion of the variation in the real exchange rates is reported to be country-specific: even in Europe country-specific movements exceed worldwide and regional common factors.