Understanding how exchange rates are perceived and how that perception affects exchange rate forecasts*

Yushi Yoshida
Shiga University

Abstract

People perceive the same level of nominal exchange rate as overvalued at one point in time and undervalued at a different point in time. To capture the perception of the exchange rate at that time, we suggest constructing the perceived exchange rate by counting the newspaper articles with phrases 'appreciated currency' or 'depreciated currency.' A shift in the perceived exchange rate (PER) index alters the dynamic response of exchange rates in time series. The PER index is a valid threshold variable to forecast future exchange rates. The forecast model with the PER index as a threshold variable (PER TAR) outperforms the model with the lagged exchange rates as a threshold variable. We also show that the forecast precision of the PER TAR model is as good as the survey forecasts by market participants.

Keywords: Dynamic Forecasting, Exchange Rate Expectations, Perceived Exchange Rates (PER) Index, Survey Forecasts, Threshold Autoregression.

JEL Classification codes: F31(Foreign Exchange), F37(International Finance Forecasting and Simulation: Models and Applications)

The RIETI Discussion Paper Series aims at widely disseminating research results in the form of professional papers, with the goal of stimulating lively discussion. The views expressed in the papers are solely those of the author(s), and neither represent those of the organization(s) to which the author(s) belong(s) nor the Research Institute of Economy, Trade and Industry.

* corresponding author: Yushi Yoshida, 1-1-1 Banba, Hikone, Shiga 522-8522, Japan. tel: 81-749-27-1089. email: yushi.yoshida@biwako.shiga-u.ac.jp. This study is conducted as a part of the Project "Exchange Rates and Japanese Economy," undertaken at the Research Institute of Economy, Trade and Industry (RIETI). The earlier draft of this paper was presented at the DP seminar of the RIETI and SWET in Hokkaiso University, and I would like to thank Keiichiro Kobayashi, Junko Shimizu, Shigenori Shiratsuka, Eiichi Tomiura, Takayuki Tsuruga, Weiyang Zhai, and the participants for their helpful comments. Yoshida thanks Ayako Yamato for her outstanding research assistance. Yoshida gratefully acknowledges financial support from the JSPS KAKENHI 25K00649.