

## Abstract

This paper arrives at two major conclusions. First, macroeconomic fundamentals do matter for exchange rate dynamics, but in a nonstandard way. They matter in that different sets of fundamental variables are significant during different time periods. Second, the basic (semi-reduced-form) assumptions of the sticky-price monetary models of the exchange rate are consistent with the data. Both of these conclusions stem from incorporating the problem of structural change on the part of reduced-form parameters explicitly into the analysis in a way that is objective and allows us to distinguish periods of time in the data characterized by relative parameter constancy. Our analysis indicates that the monetary models experience structural instability on more occasions over the modern floating rate period than previously documented, giving rise to three periods of relative parameter constancy. Within each period of stability we find that: 1) Many of the fundamental variables of standard theory are significant and enter with correct parameter signs, although different sets of fundamental variables are significant during different time periods; 2) These sets of significant variables are cointegrated, implying that there are longer-run relationships operating in the foreign exchange market; and 3) All of the structural models examined outperform the random walk model in out-of-sample forecasting by considerable margins (in some cases by a margin of 70 percent in root mean square error), indicating that the large forecasting errors reported in Meese and Rogoff [1983] are the result of allowing the forecasting experiment to run past the end of one exchange rate regime and into the next. In order to reconcile the structural change results and the finding that different sets of fundamental variables are significant during different time periods with exchange rate theory, we make use of an alternative expectational hypothesis called the theories consistent expectations hypothesis (TCEH), recently proposed in Frydman and Phelps [1990] and developed in Goldberg and Frydman [1991a,b]. We find that the empirical results of this study are generally consistent with the TCEH.