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EQUILIBRIUM EXCHANGE RATES: A GUIDEBOOK FOR THE EURO-DOLLAR RATE

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NON-TECHNICAL SUMMARY

Assessing the level of exchange rates encounters a number of difficulties. The most immediate one is to define what is meant by "equilibrium" exchange rates. There are two polar views on this issue. The first one considers that, to the extent that they are determined by market forces, observed exchange rates are always at a market equilibrium. This short-term, market equilibrium relies on fundamentals and on expectations about fundamentals. Why then worry about this short-run equilibrium? The reason is that this market-equilibrium exchange rate can be submitted to noise and speculative bubbles, hence it can largely differ from its "fundamental" value.

At the other extreme, the purchasing power parity theory (PPP, hereafter) considers price equalization as the appropriate long-run benchmark, at least for advanced economies. Thanks to the availability of very long time series and of panel cointegration techniques, there is now consensus of the literature that PPP holds in the very long run amongst advanced economies. However, deviations from PPP are long to be reversed (Rogoff, 1996). Additionally, PPP is silent on the way global imbalances can be unwound: it does not address the issue of the United States temporarily having to experience a weak dollar in order to raise its net foreign asset position towards some sustainable path.

From a practical perspective, then, these two extreme views – market equilibrium, and PPP – are of limited usefulness, since they do not address medium-term concerns about global imbalances. Therefore, a large research avenue has been developed to provide medium to long-run norms for the real exchange rate. The bottom line of these approaches is that, despite full capital mobility, current-account imbalances cannot grow forever, so some kind of exchange-rate adjustment will be needed at some point, although it is difficult to provide a timetable. The Fundamental Equilibrium Exchange Rate (FEER) pioneered by Williamson (1985), the Behavioral Equilibrium Exchange Rate (BEER) proposed by MacDonald (1997) and Clark and MacDonald (1998), and the Natural Equilibrium Exchange Rate (NATREX) introduced by Stein (1994) are probably the most popular approaches in this vein, and they are routinely used by the International Monetary Fund for exchange-rate assessment (see IMF, 2006).

In parallel, the buoying literature on global imbalances (e.g. Obstfeld and Rogoff, 2004; Blanchard et al., 2005; Gourinchas and Rey, 2007; Lane and Milesi-Ferretti, 2007) has developed largely aside from that on equilibrium exchange rates, although one outcome of this literature is to provide estimations of exchange-rate adjustments that are needed to unwind global imbalances.

In this paper, different views of equilibrium exchange rates are compared within a single, stock-flow adjustment framework. We show how each concept corresponds to a particular horizon, illustrating this through the euro-dollar case. We estimate a simple model of net foreign asset position (NFA) for a panel of 15 countries over the 1980-2005 period. Then, we calculate current-account targets defined in order to have net foreign asset positions adjust to their equilibrium levels in a given number of years. Equilibrium exchange rates are then derived based on these current-account targets. We further evidence the sensitivity of FEER estimations to underlying assumptions concerning asset prices. We compare these FEER estimates with BEER estimations based on the same equilibrium NFAs. It is concluded that, although more robust to alternative assumptions, the BEER approach may rely on excessive confidence on past behaviors in terms of portfolio allocation. Symmetrically, FEERs may underestimate the plasticity of international capital markets because they focus on the adjustment of the trade balance. Finally the BEER and the FEER appear as complementary views of equilibrium exchange rates as they depict different moods of foreign exchange markets that are used to put unequal focus on current-account adjustment over time.

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