Testing monetary model of exchange rates in emerging economies: new evidence from ASEAN 5+2 countries

Abstract

The objective of this paper is two-fold; first, to test whether exchange rates are cointegrated with macroeconomic fundamentals as the theory predicts and secondly, to examine whether flexible-price monetary models can be used to predict and forecast future exchange rates successfully. The panel cointegration tests find the series to be cointegrated. The panel group FMOLS estimation results indicate that the estimated coefficients of money supply and real output levels relative to the US, in addition to the interest rate differentials, are statistically significant and carry correct positive, negative and positive signs respectively. The findings show that monetary models could be an important tool for explaining and forecasting the exchange rates of these ASEAN 5+2 countries in the long run.