



# Present-Value Models of Exchange Rates and Other Asset Prices: Implications of Discount Factors Near One

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Carver 1

**Abstract:** Standard economic models hold that exchange rates are influenced by fundamental variables such as relative money supplies, outputs, inflation rates and interest rates. Nonetheless, it has been well documented that such variables little help predict changes in floating exchange rates, that is, exchange rates follow a random walk. Engel and West (2003) show that the data do exhibit a related link suggested by standard models that the exchange rate helps predict fundamentals. I also show analytically that in a rational expectations present value model, an asset price manifests near random walk behavior if fundamentals are integrated of order one, and the factor for discounting future fundamentals is near one. An alternative explanation for the random-walk behavior of exchange rates is that there are some unobserved variables that drive exchange rates that follow near random walks. This talk takes the approach that both explanations are possible. I am able to measure how much of exchange-rate variation could be accounted for by the Engel-West explanation, despite the fact that we do not observe the information set of financial markets. I find that the observable fundamentals (money, income, prices, interest rates) may account for about 40 percent of the variance of changes in exchange rates under the assumption of discount factors near unity.

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