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Rational expectations vs. imperfect knowledge economics: What does really drive the Polish zloty?

Abstract

An overview of the contemporary mainstream literature on exchange rate modeling clearly indicates that the rational expectations hypothesis is almost invariably taken as a point of reference in empirical investigations. It does not change the fact that almost twenty years after Kenneth Rogoff pointed to the fundamental purchasing power parity puzzles, the causes of the long-lasting mean-reversion of the real exchange rates and the causes of similarly persistent nominal and real exchange rates still appear uncertain. It is hard to overrate the implications of the RE assumptions for the empirical models of the currencies of Central-East European transition countries. In these models, the RE hypothesis is usually adopted as a routine procedure and the discussion essentially concentrates on the appreciative expectations implied by the Ballassa-Samuelsan and demand adjustments. That the appreciative expectations are recognized as a stylized fact is proven by the fact that increasing relative productivity in the transition countries is often considered the main cause of the appreciation of real exchange rates determined from tradables' prices.

This paper verifies both the rationality of expectations occurring in the Polish zloty market and the ubiquitous appreciative expectations of the Polish zloty / euro real exchange rate. The empirical analysis is conducted within the Frydman and Goldberg (2007) IKE model that assumes an imperfect knowledge of heterogenous economic agents. The modeling strategy is implemented as recommended by Katarina Juselius (2010): (i) different assumptions about the persistence of the nominal exchange rate and prices are considered, and then (ii) competing cointegrated VAR scenarios are outlined and verified. The final outcomes of the paper are as follows (i) the rejection of the RE hypothesis in favor of the IKE alternative and (2) determination of the risk premium as a predominant factor in the Polish zloty swinging in the period 1999-2011.