

Investment Driven Exchange Rate Dynamics

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Abstract

Macroeconomic exchange rate research has primarily been focused on the consumption correlation puzzle identified by Backus and Smith (1993). This research has largely ignored the dynamic correlations present between exchange rates and other macro variables such as output, and investment. In this paper I build evidence that a relationship may exist between gross national investment and exchange rates using a panel of 19 developed members of the OECD. In addition I propose a small open economy model to explain this phenomenon. Utilizing a convenience yield mechanism proposed by Valchev (2015), I build a model in which bonds have a non-pecuniary value given by their use as collateral in investment production. I then find other empirical evidence to support the validity of this model.