The Predictability of the Canada-US Nominal Exchange Rate

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The popular Meese and Rogoff (2008) finding that random walk models have better forecast performance than the economic models further buttresses the notion that exchange rates movements are difficult to forecast. However, as George Box argues, "All models are false but some are useful", this study attempts to critique this position by investigating the CAD/USD exchange rates fluctuation and the out-of-sample forecast performance of predictors identified in the literature. Interestingly, I found as in Rossi (2013) that random walk does not always produce superior forecast quality than economic models; it depends on several considerations such as the predictors used, model specification, forecast horizons, the choice of forecast tests and evaluation technique as well as the data characterization and transformation. For instance, it is found that the VAR specification of the energy commodity price (ENER) and non-energy commodity price (NONE) perform better than the random in the one-period ahead forecast. NFA and Taylor rule fundamentals outperform the random walk benchmark at longer horizons than in the shorter -1-period ahead forecasts. When the rolling window forecast strategy is used, the AvN (Amano von Norden) model is shown to produce the least root mean squared error (RMSE) of the three Error Correction Models (ECMs) examined. The fixed estimation technique, on the other hand, identifies the traditional ECM as generating the least forecast error in the same category. While the random walk forecast better than the AvN and traditional ECM in both cases, the Diebold-Mariano test shows that, at 5% significance level, the traditional ECM has the same accuracy as the random walk. This study essentially compares, under these considerations, the performance of different out-of-sample exchange rate forecasts from 2016Q1 to 2017Q4, using sample data from 1972Q1 to 2015Q4.