Nonlinear real exchange rate dynamics in Slovenia

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Abstract

We model the dynamics of the real exchange rate in a transition economy (Slovenia) in a nonlinear framework with smooth transition regression and a vector of three endogenous variables. We allow for a different transition variable in each of the individual equations included in a vector error correction model. After testing for nonlinearities, we choose the transition variables and estimate the smooth transition vector autoregression. We find strong evidence in favour of nonlinear dynamics of real exchange rate. Additionally, the real exchange rate varied asymmetrically with respect to two regimes: real depreciation and appreciation in a preceding period. The transition functions identify four periods of major shifts in the dynamics of real exchange rate that are tightly related to adjustments in monetary policy.

Keywords: nonlinear models, smooth transition vector error-correction models, real exchange rate, unemployment, wages.

JEL classification: C30, C32, E24, E31, E41.

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