Out-of-Sample Forecasting of Foreign Exchange Rates: The Band Spectral Regression and LASSO

Tatsuma Wada

Keio University

【Abstract】

We propose to utilize the band-spectral regression for out-of-sample forecasts of exchange rates. By selecting relevant frequencies for exchange rate forecasting, we are able to improve out-of-sample forecasts. International comparisons reveal that the importance of business cycle frequencies is not uniformly confirmed. The fundamentals included in the Taylor rule are shown to have a relatively strong forecasting power. Without specifying the frequency bands prior to applying the regression, LASSO can provide better out-of-sample forecasts.