Equilibrium Exchange Rate in the Czech Republic:
How Good is the Czech BEER?

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Abstract

This paper investigates the equilibrium exchange rate of the Czech koruna using the reduced form equation of the stock-flow approach advocated, for instance, by Faruqee (1995) and Alberola et al. (1999). We investigate whether or not the observed real exchange rate of the Czech koruna is close to its equilibrium value over the period from 1993 to 2004. Our empirical approach is tantamount to the Behavioural Equilibrium Exchange Rate (BEER) popularised by MacDonald (1997) and Clark and MacDonald (1998), in that the Czech real exchange rate *vis-à-vis* the euro is regressed on the dual productivity differential and the net foreign assets position, based on which actual and total misalignment figures are derived in a time series context. In other words, we check the quality of the Czech BEER. We also study the impact of a possible initial under-valuation on the estimated equilibrium exchange rate. Employing monthly time series from 1993:M1 to 2004:M9 and applying several alternative cointegration techniques, we identify a period of an over-valuation in 1997 and in 1999, an increasing over-valuation until 2002, an under-valuation in 2003 and a correction towards equilibrium in the second half of 2004.

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