

## **Error Correction Modelling and Dynamic Specifications as a Conduit to Outperforming the Random Walk in Exchange Rate Forecasting**

Imad Moosa (School of Economics, Finance and Marketing, RMIT, Australia)

The proposition that dynamic exchange rate models can outperform the random walk in out-of-sample forecasting, in the sense that they produce lower mean square errors, is examined and disputed. By using several dynamic versions of the flexible-price monetary model, it is demonstrated that while dynamic specifications outperform the static model, none of them performs better than the random walk. The results are explained by suggesting that any dynamic specification or transformation of the static model leads to the introduction of a lagged dependent variable, which in effect is a random walk component. The analysis leads to the conclusion that it is implausible to aim at beating the random walk by augmenting a static model with a random walk component.