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# The impact of monetary policy on the exchange rate: evidence from three small open economies <sup>☆</sup>

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## Abstract

This paper studies the impact effect of monetary policy shocks on the exchange rate in Australia, Canada, and New Zealand during the 1990s. Shocks are identified by the reaction of three month market interest rates to policy announcements that were not themselves endogenous to economic news on the same day. The main result is that a 100 basis point contractionary shock will appreciate the exchange rate by 2–3 percent on impact. The association of interest rate hikes with depreciations that is sometimes observed during periods of exchange market pressure is mainly attributable to reverse causality.

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## 1. Introduction

The effect of monetary policy on exchange rates has been the subject of a large body of empirical research since the early 1990s.<sup>1</sup> A central problem for this literature is the endogeneity of the variables that are used to measure monetary policy, and even of the policy *actions* themselves, to changes in the exchange rate or other economic news that might also affect exchange rates. For example, if interest rates are raised in response to a depreciation, the data might show a negative correlation between the level of interest rates and the value of the currency, even though the interest rate hike might have induced a recovery of the exchange rate or prevented it from depreciating further. This makes it very difficult to empirically assess the response of exchange rates to monetary policy, particularly in times when the exchange rate is under pressure.<sup>2</sup>

This paper presents evidence on the impact effect of monetary policy shocks on exchange rates in three small open economies—Australia, Canada, and New Zealand—using an empirical approach that focuses on tackling the endogeneity problem. The strategy is to examine the immediate response of the exchange rate to shocks associated with particular policy actions, both during “normal” times and at times of pressure on the exchange rate. The cost of this approach is that it restricts attention to the *impact* reaction of policy shocks, and thus forgoes studying the dynamics of exchange rate adjustment after the initial reaction. The benefit is that the assumptions used to identify policy shocks are much weaker than those commonly used—minimizing, in particular, the risk of reverse causality.

The methodological “parents” of this paper are the classic studies by Romer and Romer (1989) and Cook and Hahn (1989) on the effects of monetary policy actions on output and market interest rates, respectively. The methodology of these studies is extended in three dimensions. First, this paper attempts to measure the effect of policy *shocks*, rather than of the actions themselves, i.e. to disentangle the unanticipated and anticipated components of policy actions. This is achieved by using the change of a market interest rate (such as a 3-month Treasury Bill rate) on the day of a policy announcement as a measure of the “surprise” associated with a given announcement. Second, it attempts to identify policy events, through a careful reading of press reports and central bank statements, in which a policy action may have been a within-day reaction to economic news. These episodes are excluded from the main regressions (though they are included in the descriptive parts of the paper), to avoid an endogeneity problem via the policy reaction function. Third, to address measurement error due to non-policy economic shocks that happened to coincide with a policy announcement, the change in the underlying central bank policy

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<sup>1</sup>Sims (1992), Grilli and Roubini (1995), Eichenbaum and Evans (1995), Skinner and Zettelmeyer (1995b), Clarida and Gertler (1997), Cushman and Zha (1997), Fung and Gupta (1997), Faust and Rogers (2003), Bagliano and Favero (1999) and references below.

<sup>2</sup>This may be one of the reasons for the controversy on the effect of monetary policy on exchange rates during crises. See Basurto and Ghosh (2001), Goldfajn and Gupta (1999), Goldfajn and Baig (2002), Gould and Kamin (2001), Ohno et al. (1999), Kraay (2003), Tanner (2001) and Zettelmeyer (2000) for a summary and further references.

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