# GLOBAL INTEREST RATES, MONETARY POLICY, AND CURRENCY RETURNS

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# MOTIVATIONS

- In almost all open-economy macro models, monetary policy affects the real exchange rate through its impact on expected current and future real interest rates

- However, the well-known forward-premium anomaly points toward a failure of uncovered interest rate parity

# RESEARCH QUESTION

- Can monetary policy influence the real exchange rate by changing excess returns?

# EMPIRICAL STRATEGY: TWO-STAGE APPROACH

- Estimate a Taylor rule to obtain monetary policy shocks (residuals)

- Estimate an unrestricted 5 variable VAR to construct long-run interest differential (R)

- Estimate a VAR in relative monetary policy shock, real exchange rate, and the deviation of long-run interest differential from its unconditional mean to examine the effects of monetary policy on excess returns

# EMPIRICAL RESULTS

- A relative monetary tightening in the U.S. leads to an increase in the long-run interest differentials to all countries. The responses decline overtime.

- More interestingly, monetary shocks do influence long-run excess returns. Further, the responses of long-run excess returns vary by country. Negative in Canada, Switzerland, and the U.K., but positive in Japan, the Euro zone, and the set of foreign countries as a whole.

- The results are robust to breaks in monetary policy rules and time trends.

# INTERPRETATION OF RESULTS

- The response of interest differential to relative monetary policy shock is consistent with standard sticky price models in which a monetary contraction leads to an increase in real interest rate

- Findings on excess returns match the forward premium anomaly, but they are not identical

## INTERPRETATION OF RESULTS

- A risk premium is not able to account for the findings as it implies a monotonic response of $\lambda$

- Find delayed overshooting in many countries but also overreaction of real exchange rate to shocks

- Future research is required to fully understand the findings

## SUMMARY

- Overall, very nice and interesting paper

- Makes important contributions to the literature

# MINOR QUESTIONS

- On estimating monetary shocks, consider a forward-looking rule as well (Clarida and Gertler, 1997; Clarida et al., 1998)? time-varying parameters?

- On identifying breaks, let the data speak (e.g. use Bai and Perron's method) and allow for multiple breaks?

- On estimating R, use standard selection method rather than restricting 3 lags for each country?

- Why necessary to consider the "all foreign" case which requires a weighting scheme?