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# The Effects of Monetary Policy Shocks On Exchange Rates: Evidence from New Zealand and Australia

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# Abstract

This study investigates the effects of monetary policy shifts in New Zealand and Australia on the New Zealand and Australian exchange rates. The sample period used was from March 1985 to March 1998, a period where both the New Zealand dollar and Australian dollar have been operating under a flexible exchange rate regime. Three VAR models, which differ due to the variables included, were estimated.

The results show that the movements of the New Zealand and Australian exchange rates were not always consistent with theory, but the results were consistent with the results of other studies. In particular the overshooting hypothesis (which suggests that a monetary shock leads to an overreaction of the exchange rate immediately after the shock, but quickly stabilizes again) does not hold. In the majority of the cases, both exchange rates do not always overreact in response to a monetary shock and then return to the long run equilibrium exchange rate. At times the maximal impact of the monetary shock on the exchange rate was delayed and at other times the response of the exchange rate to a monetary shock was quite volatile. However, over time the exchange rate did return to its long run equilibrium rate.

Secondly, the results showed that the exchange rates did not always move in the direction anticipated. A contraction in monetary policy does not always lead to an appreciation of the domestic currency, but may lead to a depreciation of the domestic currency instead.

Finally, the results showed that monetary shocks do contribute to the variability of the New Zealand dollar and Australian dollar, but monetary shocks do not explain the majority of the movements in either the New Zealand or Australian exchange rates.

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