Global Interest Rates, Monetary Policy, and Currency Returns

Abstract

According to almost all theoretical open-economy macro models, monetary policy influences real exchange rates through its effects on expected current and future real interest rates. But monetary policy may also influence the real exchange rate through its effects on current and future expected excess returns. We implement an empirical method that measures the influence of monetary policy through these two channels on U.S. real exchange rates relative to the G7 countries and Switzerland. We find that surprise monetary tightening raises current and expected real interest rates, which works to appreciate the currency. But the effects of monetary shocks on bilateral excess returns differ from currency to currency. In some cases, the effect works to offset the real interest rate effect, while in other cases it amplifies it.