



The University of Chicago
Department of Statistics
Master's Seminar

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**“Measuring the Effects of Monetary Policy
Shocks on Exchange Rate Using VARs”**

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ABSTRACT

This paper investigates the effects of monetary policy shocks on exchange rates using Vector Autoregression models. We examine the exchange rates of five countries: France, Germany, Italy, Japan and the United Kingdom. The models we use are adopted from the paper written by Eichenbaum and Evans(1995). Our attempt in this paper is to update the data from 1990:05 to 2004:12, and compare the results of these two different time periods. In the models using a change in non-borrowed reserve ratio as the policy shock measurement, we found that the contractionary shocks to U.S. policy led to (i) transient appreciation in U.S. real and nominal exchange rates(not found by Eichenbaum and Evans, 1995) and (ii) persistent deviations from uncovered interest rate parity in favor of U.S. investments. Moreover, the results support the immediately overshooting hypothesis(not found by Eichenbaum and Evans, 1995). On the other hand, in the model using changes in the federal funds rate as policy shocks measurement, contractionary shocks to U.S. policy led to persistent appreciation in U.S. real and nominal exchange rates. Here, we find evidence support the delayed overshooting hypothesis, which was found by Eichenbaum and Evans(1995). I conclude this paper by suggesting a possible reason for different results found by different measurements of monetary policy shocks.