Effects of Monetary Policy Shocks on Exchange Rate in Emerging Countries

Soyoung Kim
Department of Economics
Seoul National University

and

Kuntae Lim
Bank of Korea

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Summary

This study investigates the effects of monetary policy shocks on the exchange rate in six emerging countries: Korea, Thailand, the Philippines, Mexico, Brazil, and Colombia. These emerging countries recently adopted inflation targeting with the interest rate policy instrument and more flexible exchange rate regime, based on the experience of advanced countries. With the adoption of monetary and exchange rate regimes that are similar to those of advanced countries, are the effects of monetary policy on the exchange rate in these emerging countries similar to those in advanced countries?

The main empirical findings are as follows. Exchange rate responses in these countries under monetary policy shocks are often puzzling in view of the standard theory. In Brazil, contractionary monetary policy shocks lead to significant exchange rate depreciation, contrary to the standard theoretical prediction of an exchange rate appreciation. In

Mexico, Colombia, and Thailand, the exchange rate responses are insignificant. In the Philippines, the maximum effect of exchange rate appreciation is found only with a delay, contrary to the overshooting theory. In most countries, the uncovered interest parity condition does not hold conditional on monetary policy shocks. These exchange rate responses in emerging countries are more puzzling than those in small open advanced countries such as the U.K., Canada, Sweden, and Australia. Further investigation suggests that the high degree of capital control imposed in emerging countries may explain the difference in exchange rate responses of emerging and advanced countries.