Interest rate and exchange rate policies assignment

Business

The theoretical relationship between the interest rate and exchange rate policies has been a debatable issue among the economists. An increase in interest rate is necessary to stabilize the exchange rate depreciation and to curb the inflationary pressure according to Mendel-Fleming model. Therefore it helps to avoid many adverse economic consequences.

There have some reasons why the high interest rate policy is considered important. First, it provides information to the market about the determination of the authorities did not allow sharp exchange rate movements as the market anticipates economic conditions and thereby reduce the range and prevent the vicious cycle of inflation and exchange rate depreciation. Second, it raises the attractiveness of financial assets in the state as a result of capital inflows occur and thus limit the depreciation of the exchange rate.

Third, it not only reduces the bevel of aggregate domestic demand but also improve the balance of payments by reducing the level of imports. The critics argue that the high interest rates endanger the ability of local firms and banks to repay foreign debt and thus reduce the probability of repayment. As a result, high interest rate will lead to capital outflows and depreciation of the currency. The currency of Australia is the Australian dollar (ADD). Exchange rate regime in Australia has grown from a regular regime of managed float through float freely. Australia maintained a fixed exchange rate Breton Woods period 1945 to 1973.

After the breakdown of the Breton Woods system in 1973 the system of fixed exchange Reserve Bank and is associated with a trade-weighted basket of

currencies. In the year 1980, many capitalist countries are in the trend of their currency float. The reason might be that they are aware of the loss of independent control by the domestic monetary policy can lead to inflation and reductions in export competitiveness. In addition, the linked exchange rate may expose the country to speculative attacks. The currency of New Zealand is the New Zealand Dollar (NZ).

The Effective Rate was rated and link Pound Sterling has been replaced by a peg to the U. S. Dollar in year 1971. The New Zealand Dollar was placed on top where floating in a controlled basis in year 1973. The exchange rate is calculated from the New Zealand dollar which is determined on the basis of a fixed relationship with the New Zealand Dollar and a basket of currencies representing New Sealant's major trading partners. Weight currencies included in the basket established their proportionate share of total receipts during the New Zealand and overseas payments where weights are adjusted quarterly.

A crawling-peg system of monthly depreciation adopted from year 1979. However, it is not possible to accept the change in interest rate policy to be purely external to stabilize the exchange rate as the monetary authorities in many countries to resort to high interest rate policy when the currency is under pressure and interest rate policy low when the currency is in sight. In other words, the decline in the exchange rate may also prompt monetary authorities to raise domestic interest rates. The objective of this paper is to ensure that the change in monetary policy is exogenous to the exchange rate.

Changes in monetary policy have substantially different effects on the exchange rate depending how they alter expectations regarding future policy. A greater understanding of the impact of interest rates on exchange rates is of interest. While it is possible to identify some of the determinants of the exchange rate, it is important to note that the effect may vary from time to time. In particular, while the terms of trade have shown a strong correlation with the exchange rate in the post- float, there is evidence to suggest that this relationship has weakened over the last 1 5 years.

Relationship is very weak in the late sass and early the sass when the terms of trade Australia has increased but the nominal and real exchange rates both declined significantly. Some part of this decline reflects the appreciation of the U. S. Dollar at the time, which in turn distributed to investors shift their portfolio towards investments in technology assets ‘ new economy’ and away from the so-called ‘ old economy’ assets prevalent in Australia. This paper is structured as follows. Firstly, we discusses about review of literature on discussed.