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The response of global equity indexes to U.S. monetary policy announcements

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This paper analyzes the impact of U.S. monetary policy announcement surprises on 15 foreign equity indexes in Asia, Europe, and Latin America. Using high-frequency data, I find a large and significant response of foreign equity indexes to U.S. monetary policy surprises at short time horizons. On average, a hypothetical unanticipated 25-basis-point cut in the federal funds target rate is associated with a $1\frac{1}{2} - 2\frac{1}{2}$ % increase in foreign equity indexes. This paper also provides evidence that U.S. monetary policy surprises, and by extension changes in U.S. interest rates, affect foreign equity indexes through their discount rate component. This finding suggests that U.S. monetary policy may be a risk factor in global equity markets.

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1. Introduction

Extensive studies have documented the influence of U.S. monetary policy on U.S. asset prices (e.g., Cook and Hahn, 1989; Jensen and Johnson, 1995; Patelis, 1997; Kuttner, 2001). Some studies suggest that U.S. monetary policy is a risk factor in U.S. equity markets (e.g., Jensen et al., 1996; Thorbecke, 1997). Recently, Bernanke and Kuttner (2005) show that U.S. monetary policy surprises affect U.S. equity markets mainly through their effects on risk premiums. The importance of U.S. monetary policy for financial markets is also indicated by the amount of private sector resources devoted to predicting future Federal Open Market Committee (FOMC)'s decisions.

In contrast, there are only a few studies that have examined the relationship between U.S. monetary policy and foreign asset prices (e.g., Husted and Kitchen, 1985; Johnson and Jensen, 1993; Ehrmann and

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Fratzscher, 2002). This relationship is important for several reasons. First, from an asset pricing perspective, studying international markets will help to determine whether a more diverse set of assets is influenced by U.S. monetary policy. If U.S. monetary policy affects foreign assets, this supports the view that U.S. monetary policy may be a risk factor in global financial markets. Second, the relationship between U.S. monetary policy and foreign asset prices is the most direct and immediate way we can measure the influence of U.S. monetary policy on foreign economies. In addition, since monetary policy impacts the real economy through financial markets, it is important for both U.S. and foreign policy makers and market participants to have quantitative estimates of the links between monetary policy and foreign asset prices.¹

Previous studies examine the response of foreign asset prices to weekly Federal Reserve's money supply announcements during the late 1970s and early 1980s when the Federal Reserve targeted the growth of the money supply (e.g., Husted and Kitchen, 1985; Bailey, 1990). Other studies examine foreign asset prices' responses to discount rate announcements (e.g., Mudd, 1979; Johnson and Jensen, 1993). These studies use daily returns to examine asset prices' reactions, but because of time zone differences the event window sometimes is as wide as three days (i.e., when the announcement occurred on Friday in the United States), making it hard to separate the effects of U.S. monetary policy from the effects of other unrelated news. Since the Federal Reserve began using the target federal funds rate as a main policy tool in the late-1980s, recent studies have focused on the effect of target federal funds rate surprises on foreign asset prices. However, existing work focuses only on a few developed countries (e.g., Ehrmann and Fratzscher, 2002; Andersen et al., 2003), which make the findings hard to generalize.

This paper examines the impact of FOMC announcement surprises on 15 foreign equity indexes, including both developed and emerging market countries, between September 1998 and November 2004. This paper focuses on equity markets because they are the most liquid asset markets for all countries in the sample. The choice of the countries in the sample is restricted by intraday high-frequency data availability. This paper also explores why foreign equities respond to FOMC announcements. To distinguish between the effect of FOMC announcements on the cash flow and the discount rate components of foreign equities, I relate the size of each country's response to the country's real (proxy for cash flow) and financial (proxy for discount rate) linkages with the United States. This is important because if U.S. monetary policy affects foreign asset prices through the discount rate component, it will provide more evidence consistent with the role of U.S. monetary policy as a risk factor in global equity markets.

This paper extends the existing literature in four dimensions. First, I use high-frequency intraday data to examine the response of foreign equity indexes to FOMC announcements in a narrow window: 1-h for equity markets in the Western Hemisphere and close-to-open (overnight) for equity markets in Asia and Europe. The narrow window helps to isolate the effect of FOMC announcements from the effects of other unrelated news, making the estimates more precise and improving the ability to relate the cross-country variation in the response to proxies for real economic and financial linkages. To my knowledge, this is the first paper to study the response of global equity indexes to FOMC announcements using high-frequency data that cover both developed and emerging economies. I only focus on equity market reactions around FOMC announcements because I want to measure equity market responses that are driven exogenously by monetary policy surprises.² Of course, surprises about U.S. monetary policy do not occur only at FOMC meetings (both scheduled and intermeeting), but also happen because of speeches or remarks from members of the FOMC (e.g., the Chairman's semi-annual testimony before Congress). However, it is harder to isolate the effect of monetary policy surprises around these events as event windows vary across events and are generally wider. Because I ignore non-meeting

¹ For example, the FOMC eased policy rate three times in the fall of 1998 to cushion the U.S. economy from the effect of worsening economic conditions in foreign economies (e.g., Asian and Russian financial crises).

² For example, a release of a much lower-than-expected U.S. non-farm payrolls report may affect both equity markets and monetary policy expectations, creating a false impression of the relationship between U.S. monetary policy and asset prices.

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