Monetary policy and the yield curve in an emerging market: the Greek case

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Abstract

This paper explores the impact of monetary policy actions on the nominal term yield curve in the Greek money market. Essentially, the monetary transmission mechanism is under scrutiny in testing monetary policy effectiveness. We focus on the dynamic inter-relationship between the short-term monetary policy instrument (Overnight rate) and market rates across the term structure. The findings are in accordance with the fact that Expectations Hypothesis monetary policy actions have a significant impact on all market rates; however, the impact is decreasing monotonically with maturity of the interest rate. © 2001 Elsevier Science B.V. All rights reserved.

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1. Introduction

The monetary policy and nominal term structure nexus has been very often at the centre of academic debate. For instance, Bernanke and Blinder (1992), Estrella and Hardouvelis (1991), and Mishkin (1990) use the slope of the yield curve as an indicator of the monetary policy stance. In general, conventional economic theory

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dictates that monetary policy actions are transmitted to the economy via their effect on market interest rates. In particular, monetary authorities use a short-term rate as its main operating instrument. Typically, the monetary policy instrument is the interbank lending rate for Overnight loans (hereafter, the Overnight rate). Real economic activity, however, such as investment and consumption, is typically thought to depend on long-term interest rates. Therefore, the effectiveness of monetary policy is heavily dependent on whether it can exert any influence on long-term rates. In other words, the monetary policy transmission mechanism takes place through the relationship between short-term (the instrument) and long-term rates. The effectiveness of monetary policy actions depends on how closely linked short- and long-term rates are. In other words, monetary policy should be able to affect the entire spectrum of maturities in order to achieve its goal, that is, affect real activity.

The standard view of the transmission mechanism is relatively straightforward. Provided that the term structure of nominal rates is adequately described by the Expectations Hypothesis (EH, hereafter), long rates are a weighted average of current and expected future short-term rates (Lutz, 1940; Shiller, 1990). By manipulating the current short-term rate, monetary authorities alter expected future short-term rates and therefore, affect long-term rates as well. Thus, if the EH is valid, monetary policy actions should cause a parallel shift of the yield curve without altering its slope.

There are two strands of literature that have investigated the impact of monetary policy actions on the yield curve. The first has mainly explored whether the dynamics of the term structure is consistent with the EH (Cuthbertson, 1996; Hsu and Kugler, 1997; Jondeau and Ricart, 1999). The findings show that even though the EH is very often (statistically) rejected, it can explain, partly at least, the behaviour of market rates.

The second strand of the literature has focused on quantifying the direct effect of monetary policy actions on the yield curve, and mainly takes the form of event study analyses (Cook and Hahn, 1988, 1989; Dale, 1993; Roley and Sellon, 1995; Rudebusch, 1995; Thornton, 1998, 2000). Also, a number of studies have explored the same issue in a time series context (Buttiglione et al., 1998; Haldane and Read, 2000). The findings are that monetary policy is able to affect interest rates; however, its impact weakens as maturities become longer, and at the very long end of the yield curve it may even become insignificant.

The studies cited above exclusively focus on developed countries with mature money markets. However, the effectiveness of economic policy and monetary policy in particular, are even more important for emerging markets such as in Greece. Monetary policy, apart from its stabilising effects around the business cycle, also and more importantly, provides a strong signalling content on the medium- and long-term monetary policy stance. In the Greek case for instance, the Bank of Greece’s long-term target is to fight inflation and attain price stability in accordance with the European Union directives. Therefore, studying the monetary policy transmission mechanism is of great significance, as it will provide insights about the role of monetary policy in the development process.
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