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The effects of monetary policy changes on market interest rates in Greece: An event study approach

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Abstract

The operational procedures of the Bank of Greece underwent major changes during the 1990s. These shifts in operational strategy made interest rates the main tool of monetary policy for the first time in Greece. This paper examines the effects of changes in the bank's operational interest rates on market interest rates at eight maturities and for different operational regimes. A major feature of our study is the application of the event study methodology used in finance, which has not been employed in any previous study on this subject. We find that changes in official interest rates had a significant influence on short-term and intermediate-term rates and that this relationship was affected by the changes in the bank's operational procedure.

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1. Introduction

Since the late 1980s we have witnessed substantial liberalisation of Greece's financial markets. Controls on cross-border capital flows have been lifted and restrictions affecting competition and price

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flexibility in domestic financial markets have almost been completely removed. The experience of other countries indicates that changes in financial structure can have important implications for the conduct of monetary policy and a number of them have substantially revised their operating procedures during the past decade as financial market changes altered the relationship between policy tools and objectives. In Greece, changes in the monetary framework and financial reform have coincided during the transition, with the Bank of Greece (Greece's Central Bank) in effect playing a dual role. It altered its operating strategy in response to the evolving financial environment, as well as instigating and guiding these changes. The complex system of controls, which had been in existence since the end of the Second World War, supported an operating strategy designed to influence the supply of credit, rather than the price of credit. However with the gradual relaxation of the complex system of controls in the late 1980s, the Bank of Greece shifted its strategy away from the control of monetary and credit aggregates towards the use of interest rates as the main tool in the transmission of monetary policy.

This paper examines the effects of the Bank of Greece's official interest rate on market interest rates at various maturities over the period 1994–2000, using daily data. The reaction of short-term and long-term market interest rates to changes in the bank's official rate provides important information about the transmission of monetary policy into the money market. But although this relationship has been investigated in a number of advanced industrial countries, it has not been examined in emerging market economies undergoing financial liberalisation, like the Greek economy. In addition, Greece is now member of the European Monetary Union, where the transmission of monetary policy has been the subject of considerable debate.

To measure the effect of central bank rates on market rates we employ the event study methodology. Event studies can circumvent many of the problems associated with the time series approach by focusing on the response of market rates in the days immediately surrounding changes in the intervention rates. Given rationality in the market place, the effect of an event, such as a change in the operational rate of the Central Bank, will be reflected immediately in market rates. Thus the impact of a change in a Central Bank's intervention rate can be measured using changes in market rates observed over a relatively short time period. In this way, we can measure the immediate impact that a change has. This information is important in the conduct of monetary policy.

The pioneering study on the channel between central bank interest rates and market rates using a similar methodology is that of Cook and Hahn (1989). The authors examine the effect of changes in the Federal Funds rate on market rates in the United States at various maturities around and on the day of changes in the Federal Funds rate. Thornton (1998) has also studied the market's reaction to federal funds rate changes, but only on the day of the change in the Federal Funds rate. Like Cook and Hahn, he obtains successively lower values as the maturity increases. Hence, for the short rates, the direct liquidity effect is the predominant influence, while in the case of longer rates, expectations are more important. On the other hand, Garfinkel and Thornton (1995) present evidence suggesting that the Federal Funds rate is a no better indicator of monetary policy than other short term interest rates. Other studies for the United States include Cook and Hahn (1988), Thornton (1986, 1994), Dueker (1992), Rudebusch (1995) and Kuttner (2000). Paquet and Pérez (1995) carried out a study for Canada and show that changes in the overnight mostcall rate induce a significant effect on the rates of assets with up to 6 months maturity. Work has also been done for European countries. Pedersen (1997) reports that changes in the Danish discount rate are found to have significant effects on market rates and the effect declines with maturity. A study by the Deutsche Bundesbank (1996) reports similar results for Germany. Neumann and Weidmann (1998) also investigate the effect of the German discount rate on the overnight rate and find that, post-