

Monetary policy signaling and movements in the term structure of interest rates[☆]

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Abstract

This paper examines how various monetary policy signals such as repo rate changes, inflation reports, speeches, and minutes from monetary policy meetings affect the term structure of interest rates. We find that unexpected movements in the short end of the yield curve are mainly driven by unexpected changes in the repo rate. However, published inflation reports and speeches also have some impact on short rates. Speeches are found to be a more important determinant for the longer end of the term structure. Our conclusion is that central bank communication is an essential part of the conduct of monetary policy.

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1. Introduction

The efficiency of monetary policy is strongly related to monetary policy signaling, i.e. the way policy makers indicate their intentions through policy reports, speeches and other communication channels. The reason for this is that important variables such as the exchange rate and long-term interest rates reflect expectations of future monetary policy. Thus, the monetary policy stance should be assessed in terms of expected future monetary policy intentions rather than the current setting of the central bank's instrument (normally a short-term nominal interest rate). Indeed, there are examples of models in which the intended future level of the official interest rate rather than its current level is considered to be the instrument for the central bank, see [Svensson \(2003\)](#).

The theoretical considerations above suggest that policy makers should try to steer a (very) long-term interest rate by signaling the intentions of future monetary policy and confirm and support such a signaling policy by adjusting the short-term interest rates. However, in practice there are several problems with such a policy device. First, it is hardly meaningful to indicate policy intentions more than a few years ahead since future monetary policy depends on future economic conditions, which become very hard to predict as the forecast horizon increases. Second, the controllability of interest rates declines with maturity since movements in long-term interest rates to a large extent reflect exogenous factors such as global interest rate trends and fluctuating term premia. It is therefore an open empirical issue to determine to what extent monetary policy signaling can affect medium- and long-term interest rates. The aim of this paper is to shed some light on this issue by examining the relationship between monetary policy signaling by the Riksbank (the Swedish central bank) and movements in the Swedish term structure of interest rates.

The literature that analyzes term structure effects from monetary policy actions includes [Cook and Hahn \(1989\)](#), [Buttiglione et al. \(1997\)](#), [Lindberg et al. \(1997\)](#), [Favero et al. \(1996\)](#), [Evans and Marshall \(1998\)](#), [Haldane and Read \(2000\)](#), [Kuttner \(2001\)](#).

This paper extends the analysis in the literature cited above in at least two important directions. First, it relates unexpected term structure movements not only to unexpected monetary policy actions, but also to unexpected changes in other important factors like foreign interest rates, surprises in the outcome of inflation, GDP and other macrovariables as well as unexpected portfolio effects. This paper is hence also to some extent related to studies analyzing macroeconomic announcement effects ([Flemming and Remelona, 1999](#)). Second, the paper broadens the concept of monetary policy actions to include (in addition to the changes in the official interest rate) signals from board member speeches, inflation reports and minutes from monetary policy meetings. These additional channels for monetary policy action turn out to be important. Like [Buttiglione et al. \(1997\)](#) and [Haldane and Read \(2000\)](#) we find that unexpected changes in the official interest rate has a quite small impact on longer market interest rates (maturity of 5 years). Moreover, unexpected signals from speeches appear to have significant effects on longer interest rates that normally are larger than those from unexpected changes of the official rate. In addition, other monetary policy signals provided from the inflation reports and the publications of minutes also seem to be of some importance. The main conclusion of this paper is that central bank communication is an essential part of the conduct of monetary policy—an aspect that recently has started to gain some attention in the literature (see e.g. [Guthrie and Wright \(2000\)](#); [Woodford \(2001\)](#)).

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