

The impact of monetary policy on stock prices

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Abstract

This paper investigates the impact of monetary policy on stock returns in 13 OECD countries over the period 1972–2002. Our results indicate that monetary policy shifts significantly affect stock returns, thereby supporting the notion of monetary policy transmission via the stock market. Our contribution with respect to previous work is threefold. First, we show that our findings are robust to various alternative measures of stock returns. Second, our inferences are adjusted for the non-normality exhibited by the stock returns data. Finally, we take into account the increasing co-movement among international stock markets. The sensitivity analysis indicates that the results remain largely unchanged.

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1. Introduction

Monetary policy attempts to achieve a set of objectives that are expressed in terms of macroeconomic variables such as inflation, real output and employment. However, monetary policy actions such as changes in the central bank discount rate have at best an indirect effect on these variables and considerable lags are involved in the policy transmission mechanism. Broader financial markets though, for example the stock market, government and corporate bond markets, mortgage markets, foreign exchange markets, are quick to incorporate new information. Therefore, a more direct and immediate effect of changes in the monetary policy instruments may be identified using financial data. Identifying the link between monetary policy and financial asset prices is

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highly important to gain a better insight in the transmission mechanism of monetary policy, since changes in asset prices play a key role in several channels.

In this paper, we provide empirical evidence on the relationship between monetary policy and one of the most important financial markets, the stock market. Stock prices are among the most closely monitored asset prices in the economy and are commonly regarded as being highly sensitive to economic conditions. In the context of the transmission mechanism through the stock market, monetary policy actions affect stock prices, which themselves are linked to the real economy through their influence on consumption spending (wealth effect channel) and investment spending (balance sheet channel).¹ As [Bernanke and Kuttner \(2005\)](#) point out, some observers view the stock market as an independent source of macroeconomic volatility to which policymakers may wish to respond. Stock prices often exhibit pronounced volatility and boom–bust cycles leading to concerns about sustained deviations from their ‘fundamental’ values that, once corrected, may have significant adverse consequences for the broader economy. Hence, establishing quantitatively the existence of a stock market response to monetary policy changes will not only be germane to the study of stock market determinants but will also contribute to a deeper understanding of the conduct of monetary policy and of the potential economic impact of policy actions or inactions.

According to the discounted cash flow model, stock prices are equal to the present value of expected future net cash flows. Monetary policy should then play an important role in determining equity returns either by altering the discount rate used by market participants or by influencing market participants’ expectations of future economic activity. These channels of influence are interlinked since more restrictive monetary policy usually implies both higher discount rates and lower future cash flows. Thus, monetary policy tightening should be associated with lower stock prices given the higher discount rate for the expected stream of cash flows and/or lower future economic activity. In contrast, an expansive monetary environment is commonly viewed as good news as these periods are usually associated with low interest rates, increases in economic activity and higher earnings for the firms in the economy. Consequently, stock market participants pay close attention to strategies based on the stance of the monetary authority as inferred by changes in indicators of central bank policy. Also, the financial press often interprets asset price movements as reaction to monetary policy shifts, attributing for instance increases in stock markets to low interest rates.

Previous empirical evidence broadly supports the notion that restrictive (expansive) monetary policy decreases (increases) contemporaneous stock returns, as well as expected stock returns.² These studies typically relate stock returns to measures of monetary policy stringency in the context of single equation specifications and/or multivariate Vector Autoregressions (VAR’s). In this paper we take a closer look at the impact of monetary policy on stock returns by utilising 30 years of data across 13 OECD countries. Given the considerable debate on the relative merits of money aggregates during the late 1970s and early 1980s, we adopt the nowadays standard approach of measuring monetary policy using interest rate variables. We expand previous work by examining the sensitivity of our findings to the inclusion of dividend payments in the stock returns calculation, while considering both nominal and real returns. Our results indicate that for the majority of the countries under investigation the monetary environment is an important determinant of investors’ required returns. This holds across a variety of returns specifications (nominal, real, dividend adjusted, non-adjusted). We also examine the contemporaneous effect of

¹ [Goodhart and Hofmann \(2000\)](#) establish empirically the link between output growth, credit aggregates, and asset price movements in a number of major economies.

² See among others, [Conover et al. \(1999\)](#), and [Thorbecke \(1997\)](#).

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