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Monetary policy announcements and stock reactions: An international comparison

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ABSTRACT

This article investigates the impact of domestic monetary policy rate announcements on the stock markets of New Zealand, Australia, the United Kingdom and the euro area, using event-study methods to identify stock price reactions to the unanticipated/surprise component of announcements. As Australia and New Zealand did not reach the zero bound we investigate whether there is an impact from the global financial crisis on stock market reactions that can be distinguished from the asymmetric reactions to surprises that characterise the business cycle. We find that the euro area and the UK both show a financial crisis effect but behaviour in New Zealand and Australia does not change. We conduct robustness checks and explore confounding factors, especially the impact of 'guidance' from central banks that prepares markets for policy rate changes.

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We have two main aims in this article: first to see whether the financial crisis has affected how stock prices respond to policy surprises. There is some evidence from the UK (Gregoriou, Kontonikas, MacDonald, & Montagnoli, 2009) that stock price responses became significantly positive during the financial crisis, which implies a striking change in behaviour. We therefore extend the existing literature to Australia and New Zealand because these two countries did not reach the zero bound for nominal interest rates and, hence used conventional policy throughout the crisis period. Beyond short run measures to ensure adequate liquidity, they did not employ quantitative easing or credit easing in addition to interest rate policy. We also include the UK and the euro area, which did reach the zero bound, as comparators.

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The nature of the likely change in behaviour in a crisis is not completely obvious. It is usually thought that in a crisis people become much more risk averse. This could mean therefore that they become more sensitive to monetary policy surprises, particularly negative ones. However, it is also thought that as monetary policy approaches the zero bound it becomes less effective, because people can see that conventional monetary policy will soon reach its limits. A negative shock could then simply accelerate the onset of the belief about policy ineffectiveness and hence show a weakened response in stock prices. As a by-product of this analysis we also get to test whether the experience recorded for the US, the UK and the euro area in normal times can be extended to Australia and New Zealand.

Secondly, we seek to substantiate the evidence that the response of markets to monetary policy surprises varies over the course of the business cycle. There is good evidence that monetary policy responses to asset prices are themselves asymmetric (Mayes & Viren, 2011 for the euro area; D'Agostino, Sala, & Surico, 2005 for the US) but little in the reverse direction, although Anderson, Bollerslev, Diebold, and Vega (2007) find that stock price responses to positive macroeconomic news, including that from interest rates, is positive in expansions and negative in contractions.¹ Simply put, it is normally thought, on the basis of previous evidence (Bernanke & Kuttner, 2005; Bredin, Hyde, Nitzsche, & O'Reilly, 2007a; Bredin, Hyde, Nitzsche, & O'Reilly, 2007b; Honda & Kuroki, 2006; Wongswan, 2005), that if there is a positive interest rate surprise this will encourage markets to fear that there is more adverse information available to the central bank than they had thought existed and hence the stock price response would be negative. However, in uncertain times such a surprise might lead markets to believe that policy will be more conducive to steady growth in the future, as the central bank appears more determined to maintain price stability than was previously thought. Montagnoli and Mayes (in press) for example show that central banks themselves tend to set policy differently under greater uncertainty.² The previous discussion of the influence of the global financial crisis suggests that the reaction of markets may be different in the down and up phases of the cycle as well as during uncertainty which is usually associated with turning points.

There is extensive evidence that, in addition to affecting inflation and the real economy, monetary policy has a clear impact on stock prices (and on house prices) (Iacoviello & Minetti, 2003; Iacoviello & Raoul, 2008). Since stock prices are forward looking that influence will come through news and monetary policy surprises. The reaction to news will incorporate the change the central bank is expected to make in the settings of policy in the light of that same news. Thus when monetary policy decisions are announced, what will move stock prices is announcements that are different from those expected. All of the countries in our sample implement a form of inflation targeting, although this is not how euro area policy is described by the Eurosystem, and try to make their policy predictable. However, they typically only announce policy decisions at scheduled meetings. Some countries also offer a projection of how the policy rate might be expected to evolve in the future in the light of current information and expected future events. In our sample this is only the case in New Zealand.

Although there is wide debate about the appropriateness of reacting to asset price changes, including stock prices,³ it is clear that monetary policy does indeed also respond to them in practice (see Mayes & Viren, 2011, for the case of the euro area and Miller, Weller, & Zhang, 2002 for the US).⁴ The relationship is therefore bi-directional. For market participants, changes in monetary policy have implications for effective investment and risk management decisions. For central banks, an understanding of the links between monetary policy and asset prices is fundamental, as has been demonstrated with unwelcome clarity in the present global financial crisis. They need to understand both how they can influence stock prices and how that influence impacts on inflation and financial stability. Our analysis here focuses on how stock markets react to policy surprises. To some extent

¹ See also Boyd et al. (2005) for an asymmetric stock price response to labour market news. They find a positive response to bad news and expansions and a negative response in contractions. This they argue is because of the expected response of monetary policy.

² They consider the Czech, Swedish and UK central banks as these have the longest history of recording perceived uncertainty.

³ Bernanke and Gertler (2001), Cecchetti et al. (2000), Filardo (2000), Goodhart and Hofmann (2000).

⁴ Rigobon and Sack (2003) show that a rise in the S&P500 index increases the probability of a monetary policy tightening at the next FOMC meeting in the US.

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