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The reaction of the Australian financial markets to the interest rate news from the Reserve Bank of Australia and the U.S. Fed

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ABSTRACT

This paper provides comprehensive evidence on the impacts of the Reserve Bank of Australia's (RBA) and the U.S. Fed's target interest rate announcement news on the Australian financial markets over the period 1998–2006. The RBA's news had a significant impact on the first moments of market returns/changes in line with *a priori* expectations, and the conditional volatility in most of the markets was significantly higher following the news. Asymmetric news effect is also observed for the Australian interest rates where markets tended to respond more strongly to unexpected rate rises than rate falls. While the U.S. Fed's news influenced only the USD/AUD exchange rate, the Australian market volatility was significantly lower in all market segments following the Fed's news.

1. Introduction

"*Policymakers often have to act, or choose not to act, even though we may not fully understand the full range of possible outcomes, let alone each possible outcome's likelihood.*" (Alan Greenspan, January 3, 2004)

There is a growing body of literature examining the news contents of central banks' interest rate target announcements. The investigations are aimed at ascertaining the presence and the nature of

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the news effects on financial markets. Recently, attention has also been directed to the spillover effects of one central bank's announcement news on another country's financial markets. Since the abandonment of monetary aggregate targeting in the mid-1980s, central banks of advanced countries have moved to targeting policy interest rates. These target interest rates are formally announced and any change thereof constitutes an adjustment in the monetary policy stance. As interest rates of longer maturities are determined by the expected levels of the target rate over the relevant time horizon, any change in the target rate has an immediate impact on other short-term interest rates.[1] Financial market participants must take positions based upon their expectations on the impending announcements of a central bank's target interest rate stance. This expected part is thus already factored into the market prices observed immediately prior to the announcement. If the actual target rate announced is different from that already priced, markets react to this surprise (or news) component accordingly. Thus, central banks influence financial markets through their control over the target interest rates and the markets' expectation on the future courses of the respective target rates.

The current literature mostly concentrates on the impacts of monetary policy news of the U.S. Federal Reserve's federal funds target rate. The Fed's interest rate news effects have been investigated on the U.S. equity market (Bomfim, 2003; Bernanke and Blinder, 1992; Bernanke and Kuttner, 2005; Lee, 2006), and on the U.S. debt markets (Cook and Hahn, 1989; Demiralp and Jorda, 2004; Gulley and Sultan, 2003; Kuttner, 2001; Roley and Sellon, 1995, 1998). Furthermore, the spillover impacts of the Fed's interest rate news have been investigated by a number of researchers. These include Bredin et al. (2005) on the Irish stock market, Ehrmann and Fratzscher (2003, 2005) on the Euro area money markets, and Hausman and Wongswan (2006) on the stock, debt and foreign exchange markets of 49 countries. The Fed's interest rate news has shown to be transmitted to these markets and the spillover effects are strongly felt. However, the transmission in the opposite direction is found to be weak (Ehrmann and Fratzscher, 2005).

In Australia, the Reserve Bank of Australia (RBA) started to announce its target interest rate (the overnight cash rate) from January 1998. The RBA Board's decision on the rate (whether or not there is a change) is announced in a media release, which states the new target for the cash rate (if there is a change) together with the rationale for the decision. The literature on the RBA's cash rate announcement effect is limited to the investigation of the announcement impact on the first moments of Australian market returns (e.g. Gasbarro and Monroe, 2004; Diggle and Brooks, 2007). The common limitation of these studies is that they only examine the overall impact of cash rate announcements rather than concentrating on the surprise or news component to which markets are responding. We aim to address this oversight by investigating the RBA's cash rate announcement news effects on both the first and second moments of daily returns/changes in the Australian debt, foreign exchange and stock markets for the period 1998–2006. Furthermore, the literature is missing a thorough investigation of the spillover effects of the U.S. Fed's interest rate announcement news on the Australian financial markets. This is another oversight in the literature as the information leadership role of the U.S. in Australia is well documented. For instance, Kim and Sheen (2000) show that the Australian interest rates (90-day and 10-year rates) react strongly to the first and second moments of the corresponding U.S. rate movements. Masih and Winduss (2006) report a straightforward cointegration relationship between the Australian and the U.S. interest rates, whereas Narayan and Smyth (2004) show similar evidence for the stock markets. Kim (2005) reports a direct causal information flow from the U.S. stock market to that of Australia.

Thus, in this paper, we have the dual aim of firstly investigating the role played by the RBA's interest rate news in the Australian debt, foreign exchange and stock markets, and secondly, documenting and discussing the existence and the nature of the transmission of the U.S. Fed's interest rate news on the Australian financial markets.

The main findings of this paper are summarized as follows. First, we find evidence that the RBA's target interest rate news has statistically significant impacts on the daily returns/changes in all three financial market segments in line with prior expectations. In particular, an unexpected rise in the target

[1] For example, the 90-day bank accepted bill rates in Australia are calculated as an average of 90 overnights expected interest rates hence.