

The impact of monetary policy candiddness on Australian financial markets

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Abstract

In January 1990, the Reserve Bank of Australia (RBA) changed from a covert disclosure policy to an overt disclosure policy. Using a sample from January 1986 to September 2001, this paper examines the reaction of Australian financial markets to rate target changes within each of these disclosure regimes. We find significantly different announcement day responses between the two disclosure regimes for both short-term and long-term treasury securities, and equity indices. Overall, the results indicate that when monetary policy is more transparent, the market reaction is less pronounced and, therefore, we conclude that fuller disclosure of monetary policy allows investors to more optimally manage their portfolios.

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1. Introduction

There are two distinct positions on how explicitly central banks should communicate monetary policy to market participants. One group argues that the option of choosing between public or non-public changes to monetary policy should reside with the central bank. The opposing group argues for a mandatory public statement of monetary policy change. This is an important issue since prior studies show that monetary policy actions of

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central banks have the ability to affect security prices in a systematic manner.¹ The impact of monetary policy changes on security prices may be a function of how explicitly monetary policy is communicated. Different methods of communicating monetary policy may affect the ability of market participants to value correctly their financial securities and to manage their portfolios.

In 1985, the Reserve Bank of Australia (RBA) began managing monetary policy through the control of interest rates. Initially, monetary policy changed covertly and only later was it acknowledged by central bankers “with winks and nods months after the event”.² During this covert regime, market participants had little knowledge of when an announcement might occur and they had to infer changes by examining the rediscount rate, which was changed irregularly.³

In January 1990, the RBA decided to publicize changes in monetary policy. At that time, the RBA announced that it would meet on a particular day each month and the next day would release a press statement specifying the official cash rate target.⁴ In addition, the press release would indicate the logic behind that target. Therefore, during this period market participants knew *ex ante* when an announcement might occur, and the only uncertainty was the magnitude of any change. This change in communication policy permits a unique opportunity to investigate the impact of differential information of changes in the administered interest rate target on the Australian financial market.

This study examines the impact of RBA target rate changes on security prices. RBA intervention was occurring during both regimes, and it is reasonable to assume market participants observed the same economic indicators as the RBA. As market conditions change, the likelihood of a change in interest rates increases, and participants adjust their portfolios to reflect these expectations. This rebalancing occurs over time and in an orderly fashion only if they know when an announcement is forthcoming. If their expectations are ultimately realized, their portfolios require little or no rebalancing, and we expect no statistically significant announcement effect. However, if the anticipation is not completely accurate or if the RBA is revealing new private information, portfolios may require substantial rebalancing, and we will observe an announcement effect.⁵ Timing is critical. If market participants do not know *when* the RBA will announce rate changes, more pronounced reactions to changes would occur.

For example, suppose economic conditions are changing and market participants expect the RBA to increase short-term rates by 25 basis points. As a market participant, we continually rebalance our portfolio to reflect our expectations. If we know the day the RBA will announce any changes, we know our expectations will or will not be confirmed on that day.

¹ See, for example, *Roley and Troll (1984), Smirlock and Yawitz (1985), Thornton (1986, 1994), Cook and Hahn (1988, 1989), Dueker (1992), Carlstrom (1995), Nilsen (1996) and Jensen et al. (1996).*

² *The Australian Financial Review (AFR) (1 March 1990).*

³ According to the AFR, the rediscount rate is “a useful tool in determining the outlook for interest rates” (6 November 1986). The Australian rediscount rate is equivalent to the US discount rate, which is the lending rate that the federal reserve banks charge depository institutions from the discount window. *Goodfriend (1991)* provides a detailed treatment of how the discount window operates in the US.

⁴ The equivalent rate in the US is the federal funds rate, which is the intra banks’ overnight lending rate.

⁵ RBA private information possibly includes knowledge of each individual bank’s current loan portfolio and future loan demands. Individual banks do not have this confidential information about the other banks.

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