

Changes in the informational content of term spreads: Is monetary policy becoming less effective?

Javier Gomez-Biscarri*

*IESE Business School and Department of Business, Universidad de Navarra,
Avda. Pearson 21, 08034 Barcelona, Spain*

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Abstract

We examine the predictive power of term spreads as predictors of economic recessions in Europe and the US. Using a battery of methodologies that include endogenous changepoint detection we find that the predictive power of spread-type variables has changed significantly during the 1980s and 1990s: in the most advanced countries the domestic spread has lost its informative content in favor of international – US and German – spreads, whereas in less developed countries this informational content has appeared during the late 1980s. Given the theoretical arguments for the predictive power, these findings suggest that domestic monetary policy may have become less effective in the most developed countries of the sample.

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1. Introduction

The mild recession that hit some of the advanced economies in 2000–2001 revived the interest for the study of economic cycles and of the management of these cycles. The theoretical literature has contributed significantly to this analysis by incorporating to dynamic general equilibrium models nominal frictions that generate real effects of economic policies (Clarida, Gali, & Gertler, 1999, 2002). In particular, monetary policy is attracting renewed attention: increased pressure is being put on policymakers to anticipate economic fluctuations and smooth them accordingly. Gathering information about current and future economic conditions becomes an important role

* Tel.: +34 93 253 42 00; fax: +34 93 253 43 43.

E-mail address: jgbiscarri@iese.edu.

of the Central Bank (CB) so that decisions can be taken enough in advance to account for lags in policy effectiveness. As a consequence, on the empirical side emphasis is being placed on the detection of variables that forecast the future evolution of the economy (Leamer, 2001; Estrella, Rodrigues, & Schich, 2003).

Monetary aggregates, exchange rates or discount rates were traditionally used as predictors of future economic activity. All these direct indicators can be problematic (Davis & Fagan, 1997), so attention turned to indirect predictive variables such as term spreads. Theoretical arguments for the predictive content of spread-type variables rely directly on the real effects of monetary policy and on the ability of the CB to carry out independent monetary policy and affect market interest rates. A substantial amount of research has shown that the informational content of the term spread about future output is high. However, most of this research has focused on the 1980s and early 1990s and on large developed economies such as the US, Germany and the UK. Little research has been done on smaller or less developed economies, and, thus, there is still much to be learned from the analysis of the predictive power of term spreads.

In this paper we study the informational content of term spreads in a number of European Union (EU) countries and in the US. We focus on whether this informational content has changed in the last two decades. More specifically, we attempt to answer the following questions:

- Do domestic spreads have information about future economic activity in a set of European nations? Has this informational content changed in the last two decades?
- If so, how has this content changed and what may be the reasons behind those changes?

Our findings are noteworthy. We show, as was already known, that term spreads indeed have had quite high predictive power in the last two decades. However, this informational content has decreased noticeably for domestic spreads in a set of countries during the 1990s, whereas it has increased in some others. The level of monetary and financial development of the country seems to be behind this phenomenon: it is in the more advanced economies where the predictive power of domestic spreads has been lost, usually in favor of international – German or US – spreads. We interpret these findings as stemming from the more intense integration of the economies, which may be both facilitating the transmission of real shocks across countries – thus cycles in the different economies are more correlated – and limiting the scope for independent domestic monetary policies.

The paper proceeds as follows. Section 2 gives simple theoretical arguments for the predictive content of term spreads. Section 3 reviews the empirical strategy used to analyze changes in this predictive power in a set of nine European countries and the US. Section 4 presents the results of the analysis and Section 5 concludes the paper. Some technicalities of the estimation procedure are provided in Appendix A.

2. The informational content of term spreads

Bernanke (1990) and Mishkin (1990) showed that the term spread, the difference between a long and a short-term interest rate, has information about future inflation and output. Assuming no liquidity or risk differences, the expectations hypothesis posits that the spread between a long and a short-term rate reflects the difference between current and expected real interest rates and inflation rates. Suppose that the CB adopts a transitory expansionary monetary policy and increases money supply. This will be associated with an immediate decline in nominal and real short-term rates. However, long-term rates will move down by a lesser amount, both because a

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