The impact of conventional and unconventional monetary policy on expectations and sentiment

Emilios Galariotis\textsuperscript{a}, Panagiota Makrichoriti\textsuperscript{b}, Spyros Spyrou\textsuperscript{b,}\textsuperscript{*}

\textsuperscript{a} Audencia Business School, Institute of Finance, Nantes, France
\textsuperscript{b} Athens University of Economics and Business, Department of Accounting and Finance, Patission 76, 10434, Athens, Greece

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\textbf{A B S T R A C T}

This paper offers evidence on the effect of ECB’s conventional and unconventional monetary policy on economic expectations in Euro-area countries during the US and EU crisis. We employ a range of research methodologies in a sample of nine Eurozone countries and combine expectations/sentiment indicators with a set of macroeconomic and financial variables. We find that ECB’s conventional monetary policy (and Fed’s monetary policy stance) has a positive and significant effect on economic expectations for Core Eurozone countries and a weak effect on Peripheral Eurozone countries. ECB’s unconventional policy measures, however, have a negative short-term effect on Core countries’ economic expectations. This result is robust to different methodologies (PVAR, QVAR, FAVAR) and different datasets. Overall, our findings highlight the importance of monetary policy in the determination of economic expectations.

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\textbf{1. Introduction}

The main aim of the European Central Bank (ECB) is to maintain price stability; in addition it contributes to the stability of the financial system within the Euro-area by monitoring developments in the banking and financial sectors. The main instrument of monetary policy by central banks is their influence over money market interest rates, which affect expectations of future official interest rates, the actions of economic agents, and ultimately the evolution of output and prices. As the ECB itself acknowledges, the expectations transmission channel of monetary policy has gained importance during the recent decades. For instance, a high degree of central bank credibility can have a strong impact on price developments by guiding economic agents' expectations, and thus "...understanding the transmission mechanism is crucial for monetary policy" (p.61, The Monetary Policy of the ECB, 2011; \url{http://www.ecb.europa.eu}).

Furthermore, as Lutz (2015) argues, there is a necessity to understand the relationship between investor sentiment and monetary policy since central banks are contemplating the use of monetary policy tools in order to tackle the volatility associated with asset bubbles and financial crises. Indeed, during the recent financial crises in the US and the EU, official policy rates approached the zero lower bound and, as a result, central banks in developed economies resorted to unconventional monetary policy mechanisms in order to tackle financial market volatility and preserve financial stability (see, Gambacorta et al., 2014; Fawley and Neely, 2013).

This paper examines the effect of ECB’s unconventional and conventional monetary policy during the EU crisis on economic expectations.\textsuperscript{1} For monetary policy to achieve the target of price stability it has to affect expectations, in other words, affect consumer and economic confidence. We ask whether ECB’s monetary policy during the recent crises does that, since previous studies on unconventional policies focus on the Fed and US data. Lutz (2015), for example, studies the effect of Fed’s conventional and unconventional monetary policy on investor sentiment and finds that during conventional policies a surprise drop in the fed funds rate has a positive impact on investor sentiment that lasts several months; unconventional monetary policy shocks have a similar impact on economic sentiment. Also, Gambacorta et al. (2014) examine the macroeconomic effects of unconventional monetary policy and find a positive effect on economic activity following exogenous increases in central bank balance sheets. We also examine the effect

\textsuperscript{1} Many previous studies document the effect of economic agent expectations on economic activity, economic and investment behavior, and asset prices (see, among others, Benhabib et al., 2016; Chen, 2011; Hwang, 2011; Bachmann and Sims, 2012; Baker and Wurgler, 2007; Brown and Cliff, 2004; Fisher and Statman, 2003; Neal and Wheatley, 1998).
of the Fed’s monetary policy stance on economic expectations in the Euro-area and sentiment spill-overs from the US to the Euro-area. The paper contributes to the relevant literature on the effects of monetary policy. For example, Bernanke and Kuttner (2005) find that the Fed’s monetary shocks have a significant impact on expected excess equity returns and suggest that investors may over-react, or be very sensitive, to monetary shocks. This result is consistent with Kurov (2010), who finds that the Fed’s monetary policy decisions have a significant effect on US investor sentiment, or with Bekaert et al. (2013) who document a relationship between investor risk aversion and monetary policy. Neuenkirch (2013) focuses on the effect of central bank communication on monetary policy transmission and finds that it has a similar influence on expectations about inflation as that of actual target rate changes. Neuenkirch (2013) argues that communication has become an important tool for central bankers, since regular information releases about monetary policy can affect rate expectations before actual rate changes.

For the empirical analysis, we use a range of methodologies where we combine sentiment indicators with a set of monetary, macroeconomic and financial variables. For the investigation of the conventional monetary policy effect on investor’s expectations, a panel VAR setting is employed, which allows us to combine the traditional VAR modeling with a panel-data approach that allows for unobserved individual heterogeneity (see, Love and Zicchino, 2006). In order to study the effects of ECB’s unconventional monetary stance we use a Qual VAR model (Dueker, 2005), which combines the binary information of the unconventional monetary announcements with an otherwise standard VAR; i.e. it allows the use of unconventional policy announcements as an endogenous factor of the system. In other words, the Qual VAR model allows us to derive the latent propensity of ECB’s unconventional monetary stance. In order to robust the results concerning the unconventional monetary policy effects, we also employ a Factor-Augmented VAR (FAVAR) model (Bernanke et al., 2005), that combines the standard VAR analysis with factor analysis and utilizes a large number of informative macroeconomic and financial time series used by investors and policymakers. As an indicator for unconventional monetary policy in the FAVAR model we use the latent propensity of ECB’s unconventional monetary stance produced by the Qual VAR model. It is the first paper that uses the latent propensity for ECB’s unconventional monetary stance deriving from a Qual VAR model (Dueker, 2005) as a monetary instrument, combining this way, the Qual VAR and FAVAR methodologies. Our sample consists of nine Eurozone countries that we group in two sub-samples denoted for simplicity as the “Core” countries and the “Peripheral” countries. We measure the expectations of economic agents in the Euro-area with the Economic Sentiment Indicator (ESI), which is a composite index with five sectoral confidence indicators as constituents, compiled by the European Commission.

We find that ECB’s conventional monetary policy (and Fed’s monetary policy stance) during the EU crisis has a positive and significant effect on economic expectations for Core Eurozone countries and a weak effect on Peripheral countries. Moreover, the Main Refinancing Operations rate appears to be the single most important net sender of shocks to the peripheral countries, while for the Core countries it is the second most important net receiver. Our results, however, indicate that the effect of ECB’s unconventional measures on expectations was less efficient compared to the effect of conventional measures. More specifically, in contrast to previous results on the Fed unconventional policy, ECB’s unconventional measures had a negative effect to the expectation variation in core countries.

Our findings of a positive effect of conventional policy on sentiment are consistent with previous findings, however, the finding of a negative effect of unconventional policy on sentiment is not. Lutz (2015) finds that Fed’s unconventional monetary policy shocks have a similar impact on economic sentiment as conventional policies (see also, Frazscher et al., 2013, 2014). An explanation for the differences in the results may be the different nature of unconventional policies the two central banks followed after 2010. For example, one should make the distinction between the subprime crisis in the US (2007–2009) during which the reaction of the Fed and the ECB was similar, and the EU crisis that erupted in 2010 where there have been important differences in the policies employed. More specifically, as Gros et al. (2012) point out, while the Fed (and the Bank of England) responded with QE policies signaling a strong will to undertake credit risk, the ECB responded with an approach that could be described as ‘credit easing’; that is, the massive response to the crisis with the Long Term Refinancing Operations (LTROs) and the Securities Markets Programme (SMP) was also targeted at minimizing ECB’s own risk (p. 5). It must also be noted that while at the time the focus in the US was on the economic cycle and economic recovery, in the Euro area increased uncertainty about a Greek default, the effective isolation from the inter-bank market of some Peripheral country banking systems, and the restoration the monetary policy transmission mechanism, was the priority (for a detailed discussion see Gros et al., 2012).

These results have implications for policy makers. For instance, a prolonged period of low interest rates reduces the efficiency of the main policy instrument used by central banks, which may have to rely increasingly to non-standard measures to deal with future financial crises. Of particular interest to policy makers could be the finding that the formation of economic expectations following a monetary policy shock is not uniform among Eurozone countries: expectations seem to be more affected in Core rather than Peripheral Eurozone countries. Understanding these effects can help design more efficient policy tools. The rest of the paper is organized as follows: Section 2 briefly reviews unconventional monetary policy actions, Section 3 presents the data and the testing methodologies, Section 4 presents the results, whilst Section 5 concludes the paper.

2. A brief review of ECB’s unconventional monetary policies

The significance and the strength of the subprime crisis in the US (2007–2008) and the financial crisis in the EU (2010–2013) led to unchartered territory for major central banks, which responded by adopting non-standard monetary policy actions (see, for a review, Fawley and Neely, 2013). Initially, the ECB, together with other central banks from developed economies, responded by reducing its key interest rates and as a result the main refinancing rate was reduced to 1% (a decrease of 325 bp between October 2008 and May 2009). In addition to rate cuts, the ECB implemented the Enhanced Credit Support (ECS) that mainly consisted of an extension of the maturity of liquidity provision in Longer-Term Refinancing Operations (LTROs), Supplementary Long Term Refinancing Operations (SLTROs), and “Very” Long Term Refinancing Operations (VLTROs); a fixed rate full allotment tender procedure where, in contrast to standard procedures, financial institutions in the euro-area had unlimited access to central bank liquidity at the main refinancing rate; currency swap agreements that allowed the provision of liquidity in foreign currencies during the crisis; collateral requirements that involved an extension of the eligible collateral accepted in refinancing operations; a covered bond purchase programme.2

2 For instance, in March 2008 the ECB introduced 6-month SLTROs, in May 2009 the ECB announced for the first time 12-month SLTROs (in the largest 12-month auction the ECB allotted around 442 billion euro), in December 2011 the ECB announced two “very” long term refinancing operations (VLTROs) with a 3-year ma-
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