

Non-technical summary for 'Monetary Policy, Equity Markets and the Information Effect'

By Calvin He

How monetary policy affects the economy is a central question in macroeconomics. Standard economic thinking predicts interest rate cuts boost economic activity. But this idea has recently been challenged by claims that changes in monetary policy have a so-called 'information effect'. Under the information effect hypothesis, people perceive cash rate cuts to be revealing negative economic information. This revelation makes them more pessimistic, which leads them to consume and invest less. Some claim this effect is so strong it reverses the otherwise expansionary effects of cash rate cuts. This chain of events runs counter to standard economic thinking.

So, could interest rate decisions generate an information effect that reduces or even reverses the standard effects of monetary policy? In this paper, I use the lens of equity markets to shed light on this question. I find little evidence that the information effect is an important channel in equity markets. Instead, the results support standard economic thinking: earnings forecasts and equity prices rise following a cut in the cash rate.

In more detail, I use financial data around Reserve Bank of Australia (RBA) Board decisions to estimate the effect of unexpected cash rate changes on 2 equity market variables from the ASX 200: equity earnings forecasts and equity prices. These equity market variables are useful in assessing the information effect as they move quickly when new information is revealed. If the information effect dominates we would expect people to become more pessimistic after an unexpected cash rate cut, and this would cause earnings forecasts and therefore equity prices to fall.

Contrary to the predictions of the information effect hypothesis, however, I estimate that the ASX 200 earnings growth forecasts one year into the future increase by 1.9 percentage points following a 100 basis point cut in the cash rate. And the ASX 200 index increases by around 3 per cent following the same cash rate cut. These results show that the information effect does not dominate the equity market response to cash rate changes. I cannot rule out the possibility that the information effect may still exist but only reduces (rather than reverses) the standard effects of cash rate changes.

While the main analysis focuses on cash rate announcements after Board meetings, the RBA also communicates through speeches, the release of forecasts, or the Board meeting minutes. When evaluating these other media I find that equity markets respond to the Governor's speeches in a way that is consistent with the information effect. This suggests that certain forms of RBA communication may indeed reveal information that then causes people to change their economic outlook. However, this result is only found for speeches by the Governor, making it the exception rather than the rule.

The findings of this paper have implications for the conduct of monetary policy in Australia. Primarily, the work indicates that the information effect is small enough such that standard thinking of how interest rates affect the economy can continue to guide monetary policy decisions. That said, the findings do not rule out the information effect from occurring. It could be that the information effect is present under certain economic conditions, in sectors not represented by equity markets, or when using specific communication tools (in this case, the RBA Governor's speeches). But overall, whatever the information effect, it appears to be sufficiently small that it doesn't affect our standard understanding that interest rate increases are contractionary and decreases are expansionary.