MONETARY AND CREDIT DATA HELP FINANCIAL MARKETS PREDICT ECB INTEREST RATE DECISIONS

Monetary and credit data released by the European Central Bank (ECB), not just official communications and inflation and output projections, help markets to predict future interest rate moves, according to analysis by Alexander Jung, to be presented at the annual congress of the European Economic Association in Geneva in August 2016.

The ECB is one of the few central banks to emphasise the importance of its monetary data releases to check its economic analysis. With the exception of the early years of monetary union, many researchers doubt that monetary data provide useful additional information to the markets. But by analysing data for the period 2000 to 2014, the new study demonstrates that information contained in the ECB press releases on money and credit developments has helped markets in forming their expectations on the next monetary policy decision.

The empirical analysis compares two forecasting models for the ECB’s interest rates: one on the day before the publication of new monetary data; and one on the day after. The author concludes: ‘In the very short term, markets make use of new information from the monetary data releases and thereby improve their expectations of the next interest rate move.’

More...

The ECB is one of the few central banks in the world emphasising the importance of a separate monetary analysis as a cross-check of the economic analysis. Many researchers and observers have raised doubts that the monetary analysis may provide any value added.

This study provides empirical evidence illustrating the importance of monetary analysis for understanding the monetary policy of the ECB. It contributes to the important debate on whether markets do monitor monetary and credit aggregates or whether they just rely on monitoring economic developments.

Previous studies have shown that the monetary policy of the ECB is very predictable, implying that markets are well informed. Markets systematically obtain information about the future monetary policy stance of the central bank from a wide range of economic indicators, most prominently the inflation and output projections, but also from official communications (such as press conferences, speeches and websites).

Therefore, it may seem that the regular communication of the ECB on these developments is sufficient for markets to anticipate interest rate changes by the central bank. But using data for the monetary union (sample 2000 to 2014), this study shows that the monthly publication of monetary and credit data has indeed helped financial markets in forming their expectations on future policy decisions of the ECB.

Overall, the research enhances understanding of the communication role of the ECB’s monetary analysis by showing that, in the very short term, markets make use of new information from the monetary data releases and thereby improve their expectations of the next interest rate move. Markets take into account information from new releases of monetary data when forming interest rate expectations for the next meeting.
Previous studies have suggested that the market reaction to M3 releases was only strong in the early years of monetary union. A structural change in the relationship occurred coinciding with the adoption of the ECB’s non-standard monetary policy measures after June 2010 and the adoption of forward guidance in July 2013.

The main result of this study – that markets can learn something about future interest rate moves from the ECB’s monetary data releases – is robust for both samples. The results confirm that monetary surprises for M3 were a significant predictor of forthcoming interest rate changes during the first decade of monetary union, despite the fact that the coefficient had the wrong sign. It is therefore likely that markets have obtained their clues in real-time from other monetary indicators reported in the press release, such as M1 and loan developments.

But in an environment of forward guidance, the results may change. Since this episode is only recent, future research can analyse whether these results also hold during the episode of forward guidance.

In technical terms, the study conducts a novel econometric approach based on an Ordered Probit model explaining future policy rate changes in combination with the Vuong test for model selection. The empirical analysis compares two competing forecasting models for the ECB’s interest rates, one on the day before and one on the day after the publication of new monetary data.

In particular, the study tests whether monetary data releases contain information about the correct direction of the ECB’s next interest rate decision, which would allow market participants to (systematically) improve their predictions of the next policy move.

ENDS

Have monetary data releases helped markets to predict the interest rate decisions of the European Central Bank?

Author and affiliation:

Alexander Jung (E-mail: alexander.jung@ecb.europa.eu) is Senior Economist at the European Central Bank, Directorate Monetary Policy, Sonnemannstr. 20, D-60314 Frankfurt, Tel. 00496913447674, Cell phone: 00491776091175.

The views expressed by the author are his own and do not necessarily reflect those of the ECB. The author remains responsible for any errors or omissions.