
Assessing the impact of macroeconomic news announcements on securities prices under different monetary policy regimes

Working Paper No. 125

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On 6 May 1997 the UK government granted the Bank of England operational independence with respect to the implementation of monetary policy subject to an inflation target, later set at $2\frac{1}{2}\%$ per year. Since this date the Bank has tried to be as transparent as possible in its decision-making process. This paper looks at the extent to which the Bank has been successful in this aim by comparing financial market reactions to key monetary policy announcements before and after Bank independence. It also considers whether the reaction of market participants to key macroeconomic data releases has changed.

To address these issues we use high-frequency data from LIFFE and from the foreign exchange market, monitoring the prices of the short sterling interest rate, long gilt and FTSE 100 contracts and the dollar/sterling and Deutsche Mark/sterling exchange rates from immediately before to just after the scheduled announcements. We concentrate on a narrow window around these announcements in order to capture the 'pure' reaction to the announcement itself. Many other announcements occur during a trading day and cloud the picture if prices at close of business on successive days are used (as in some other studies).

The methodology involves splitting the sample period into days when scheduled announcements are made (announcement days) and days when they are not (non-announcement days). The set of non-announcement days represents a 'norm' against which to measure any unusual activity following scheduled announcements. We can compare the behaviour of the market when, for example, RPI

announcements are made, with those days when RPI announcements are not made. This is done for the period prior to Bank independence and for the period after Bank independence, and we test for systematic differences in price volatility and trading activity between the two periods.

The results indicate that there may well have been changes in the way that financial markets incorporate key economic data into securities prices. The total (cumulative) reaction of the LIFFE contracts and exchange rates to interest rate changes appears to be either unchanged or lower in the post Bank independence period, depending on the market observed. This supports the idea that the news content of monetary policy announcements may have fallen. However, while the total reaction supports this view, the more immediate reaction to interest rate changes is found to be higher in the post-independence period for all the markets studied. We also tested for a change in the way that these markets absorbed macroeconomic data following Bank independence. Looking at exchange rate responses, there is very clear evidence to support the idea that foreign exchange market agents now pay more attention to UK macroeconomic data announcements than in the pre-independence period. This evidence appears to suggest that the underlying economic data have become more important in these markets relative to the key monetary policy announcement. A different picture emerges when we consider the impact of the same set of announcements on all three LIFFE contracts, which is lower in the post Bank independence period at all horizons.