US Monetary Policy Announcements and the Term Structure of Interest Rate Differentials: Evidence from Hong Kong and Singapore

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Summary

In recent years a great deal of attention has been paid to understanding the relationship between monetary policy and market interest rates. A common empirical finding is that unanticipated changes in the US Federal Reserve target rate cause US bond yields to move substantially. Most of the contributions in this literature have focused exclusively on the US market. Surprisingly, little attention has been paid to understanding the relationship between US monetary policy actions and international market interest rates. In internationally integrated financial markets, interest rates co-move to a larger extent and Federal Open Market Committee (FOMC) announcements are likely to influence the dynamics of market interest rates not only in the US but also in other countries. The magnitude of this response is also amplified by the fact that many economies are linked to the US economy by different exchange rate arrangements.

In this paper we examine the impact of US monetary policy announcements on the term structure of interest rates for three countries: the US, Hong Kong and Singapore and by using short-term interest rate futures prices to proxy for US monetary policy surprises, we analyze the effect of US monetary policy announcements on the behavior of the US term structure of interest rate differentials with Hong Kong and Singapore.

Our results, obtained over the period spanning the last decade, show that US monetary policy announcements do affect market expectations about the future path of short-term interest rates which, in turn, substantially influence the term structure of interest rates in the US and, most importantly, in both Asian countries. The responses of market interest rates are very similar for the US and Hong Kong, while the response of market interest rates in Singapore is generally different. This suggests that exchange rate arrangements may have played a specific role in the determination of interest rates in both Asian economies. However, it is worthwhile noting that some similarities can be recognized only after classifying FOMC announcements to extrapolate Fed reactions to new information about the state of the US economy.