Asymmetric financial markets reaction to ECB monetary policy

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1 Summary of the paper

As for many other central banks, the recent monetary policy tightening launched in the euro area is a risky bet for the European Central Bank (ECB). Indeed, higher interest rates are necessary to tackle high inflation, but on the other hand, it could threaten financial stability. The main challenge for the ECB is then to raise its key policy rate enough to fight inflationary pressures, but not too much to avoid triggering financial instability in the euro area.

Although the role of the ECB in mitigating financial turmoil has been mainly studied through the lens of monetary easing in reaction to the 2008 financial and 2010-12 sovereign debt crises, little has been done on the effect of monetary policy tightening on financial markets in the euro area. This paper raises the question of the asymmetric effect of monetary policy on financial markets. Moreover, there is only little evidence of the lags in the effect of monetary policy on financial markets. The main purpose of this paper is then to focus especially on the time lag of monetary policy transmission to asset prices: are transmission lags in the effects of monetary policy on financial markets asymmetric?

The present paper empirically investigates possible asymmetries in the lagged effects of monetary policy on financial markets in the Eurozone. More specifically, I employ local projections using a panel of euro area countries to estimate the dynamic response of financial indicators to unexpected monetary policy shocks. I assess whether the reaction of financial markets to monetary policy differs according to the sign of the shock.

The main results of this paper can be presented as follows. *(i)* Overall, the transmission of ECB policy to euro area financial markets has long and variable lags. The average lag length is between 1 and 2 years. *(ii)* There is a strong asymmetric effect of ECB monetary policy on asset prices in the euro area. Since the effect of negative monetary policy shocks (i.e. monetary easing) is large and persistent, the effects of positive monetary shocks (i.e. monetary tightening) on financial markets are delayed and non significant on impact. *(iii)* In line with the literature, I find considerable Fed information effect on euro area financial markets. Regarding U.S. monetary policy, the sign of the shocks does not matter in financial fluctuations in the Eurozone.

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