MONETARY POLICY EFFECTIVENESS & YIELD CURVE DYNAMICS – US EXPERIENCE FROM A HETEREGENEOUS ECONOMIC PERSPECTIVE (2000-2009)

MOHAMED Z. M. AAZIM[1]

National Graduate Institute for Policy Studies (GRIPS), Tokyo and Central Bank of Sri Lanka (CBSL)

Email: mzmaazim@gmail.com

Abstract

The question of how do the monetary policy translate across the yield curve remain at the forefront of many recent policy debates. The monetary policy targets the very short end of the yield curve although real economic activity is largely dependent upon the medium to long- term market interest rates. Conventional wisdom agree that given efficient market conditions decrease in the monetary policy target rate leads to an immediate decrease in market interest rates, and an increase in bond prices; yet evidence for this view is elusive. Bringing the foundations of Expectation Hypothesis (EH) and empirical analysis of US money market and government bond daily yield rates for the period 2000 to 2009 explains that monetary policy impact monotonically decreases over the yield curve. The impact appears to be waning at a faster pace and concentrate on a preferred habitat towards shorter end at times of financial and economic uncertainties compared against stable economic period. This invites policy attention, especially at times of economic uncertainty, on the part of monetary policy effectiveness and market confidence in US to resurrect economic activities.

Keywords: Monetary policy; Expectation hypothesis; Segmented market hypothesis; Preferred habitat hypothesis; Yield curve and term structure of interest rates

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[1] Reading for his PhD at the National Graduate Institute for Policy Studies (GRIPS), Tokyo and an Economist by profession working for the Central Bank of Sri Lanka (CBSL). Author wishes to thank James R. Rhodes and Roberto L. Gonzales of GRIPS, N.S. Cooray of International University of Japan and Koichi Hamada of Yale University for their valuable comments and Rizwana Aazim for the editorial support extended. Any errors and omissions are, however, of the author.