

Inter-Links between Monetary Policy, Economic Activity, and the Stock Market

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Abstract

In this study we investigate the interrelations between monetary policy and economic activity and the stock market. The significance of this study is based on the need to understand the processes that characterize the relations between monetary policy and real economic activity, and the conduct of share prices, in order to assess the impact of policymakers' decisions on the financial market, on the one hand, and the effects of changes in the financial market on macroeconomic variables. The main findings of this study are: (1) monetary policy and developments in real economic activity has a significant impact on share prices; (2) The monetary policy adopted by the BOI in recent years, including unexpected changes in monetary interest rates, increased volatility of the shares traded on the TASE, and especially when actual interest was higher than expected; In such cases, share prices tended to drop; (3) Similarly to the majority of developed financial markets, despite a statistically significant bi-directional causal relationship between the share market and monetary policy and real economic activity, changes in share prices cannot be used to forecast economic developments. The main conclusion of this study is that knowledge of the government's fiscal policy and the BOI's monetary policy is important to prevent unnecessary volatility in share prices.

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