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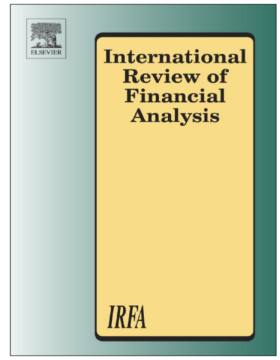

Monetary policy shocks and financially constrained stock returns: The effects of the financial crisis

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Monetary Policy Shocks and Financially Constrained Stock Returns: The Effects of the Financial Crisis

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Abstract

This study provides comprehensive evidence on the return response of financially constrained firms listed on London Stock Exchange (LSE) to UK monetary policy shocks extracted from the Bank of England's MPC meetings relative to expectations embedded in interest rate futures prices, during the period June 1999- December 2011. Using a large number of financial constraints proxies, we find no significant evidence that the most constrained firms' returns are more responsive to monetary policy shocks relative to the least constrained ones, as the credit channel of the monetary policy transmission mechanism would suggest. We also show that the inverse relationship between interest rate shocks and UK stock returns reversed its sign and became significantly positive during the recent financial crisis period. Our results show that the Bank of England can affect stock market valuations by modifying interest rates, but this impact is much stronger during periods of tight credit market conditions. Hence, apart from the credit conditions in the wider economy, central banks should also monitor the response of capital and money markets' participants to their policy decisions.

JEL classification: G12; G15.

Keywords: Monetary Policy Shocks, Financial Constraints, Credit Channel, Bank of England, London Stock Exchange.

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