Don’t underestimate central banks

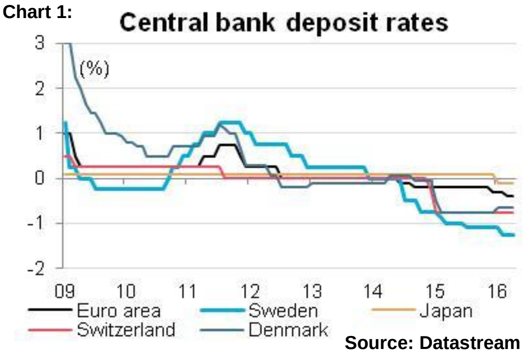
May 2016

Monetary policy has become more unorthodox in recent years, with several major central banks pushing interest rates into negative territory. This has seen investors question whether monetary policy has reached its limits leaving economies and markets now vulnerable to future shocks or weakness. Tim Rocks, Head of Market Research and Strategy, reviewed the performance of some of the countries who first adopted negative rates and found unconventional monetary policies have had a powerful effect on growth in Sweden.

During the global financial crisis, many central banks pushed interest rates close to zero. Since then, economic recovery has continued to disappoint, forcing some to adopt additional unconventional measures. The US and Japan embraced quantitative easing, while interest rates were pushed below zero in Europe.

The situation of negative interest rates applies to money deposited by banks with the central bank. The rationale for this was to encourage banks to increase lending rather than retaining excess cash, and also to depreciate the currency to boost exports. Sweden and Switzerland led the charge into negative deposit rates from 2014 as shown in Chart 1.

Chart 1:



Source: Datastream

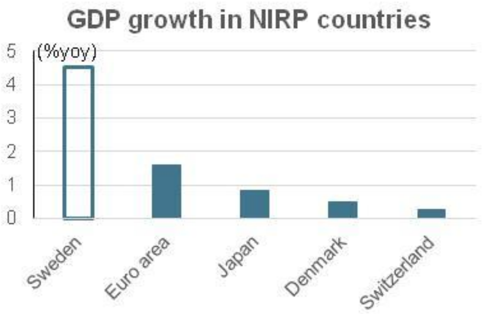
Many investors have been skeptical about the move to negative rates, doubting the ability of these to have a meaningful impact. They have interpreted the move as a signal that monetary policy is at its limit, leaving little buffer for future economic or financial problems. There are also concerns that negative rates may undermine the health of the financial sector – if banks decide not to pass on the cost of negative deposit rates to customers, they must accept a squeeze on their profit margins. In addition, there are fears negative interest rates may encourage excessive risk taking by investors as they seek a higher rate of return.

The fact is, no one really knows whether negative rates will be positive or negative in the long run as it has never been done before. However, there is growing evidence that negative interest rates have had a positive impact in the countries which embraced them first. The strongest example is Sweden.

The Riksbank, Sweden’s central bank, cut its policy rate below zero and began the first of a series of asset purchase programs in early 2015. It also signaled its readiness to intervene in the currency market if the Swedish Krona continued to appreciate to uncomfortable levels. The Riksbank wanted to use these measures to push inflation back towards its target.

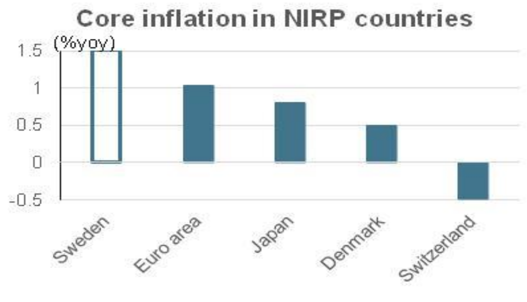
The charts below demonstrate Sweden’s success compared to other economies with negative interest rates. Activity indicators are now well above trend in Sweden, making it one of the fastest growing advanced economies. Inflation is also moving back towards its target, compared to subdued growth in other countries.

Chart 2:



Source: Datastream

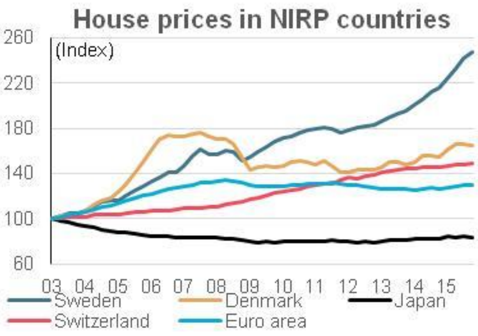
Chart 3:



Source: Datastream

Another byproduct of the negative interest rates has been a powerful housing boom in Sweden. Housing prices have risen by ~10% per annum in recent years and Sweden now has one of the highest levels of household debt in the world tied to the increased value of housing as investors feel more confident to invest, and have greater access to loans, as shown in the charts below. Mission accomplished.

Chart 4:



Source: Bloomberg

Chart 5:

Source: Bloomberg

Unorthodox central bank policy has rattled investors, given questions over how they work and their impact. However, we think central banks should not be underestimated. They have a lot more scope to support activity and stabilise markets where needed. Sweden offers a powerful example of where using negative interest rates as part of other policy initiatives can work. Time will tell whether the approaches others have used will also have the same success.

As negative interest rates seek to encourage lending and consumer spending though, sharemarkets and property can benefit from these because it is cheaper to borrow money, and there is less return from holding funds in the bank in countries with those rates. Alongside Sweden, other European countries have seen some benefit in these areas from the negative official interest rate from the ECB.

On an Australian front, we still have one of the higher official interest rates on offer, despite the recent decrease from the RBA. There is plenty of room to move before the RBA would need to consider a negative interest rate and a number of policy actions in play to support the economy already. Australian fixed interest tends to offer better returns at the moment when compared to international fixed interest, though as a whole, the best opportunities for investments are likely to be areas that can benefit from low interest rates like sharemarkets or property.

For more information on the impact of central bank policy on your clients' investments, please contact your BT relationship manager.