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Market Insight

Central banks begin to diverge

Looking at macroeconomic events over the past few weeks it is becoming increasingly clear that central banks around the world are considering different monetary policy frameworks going forward; many central banks were forced to follow similar policies of cutting interest rates as quickly as possible over the past 18 months due to severe funding constraints and plummeting output. Now that the recovery story is gaining momentum, central banks are reacting by putting in place policy measures to suit their respective territory/currency best, assuming demand continues to recover. This was of course expected; removing emergency measures and raising interest rates must occur at some stage but the timing of these measures was not expected to occur so soon. Last week, the Federal Reserve put forth plans to begin withdrawing quantitative easing measures in October. The Norwegian central bank (Norges Bank) is suggesting that forthcoming interest rate rises will be sharper than expected. Japanese officials are also voicing a quite tone of optimism by saying that government backed support could be removed in December if current levels of improvement are maintained. The UK's Bank of England on the other hand has recently increased asset purchases (QE) beyond expected limits up to £175bn and the Swiss National Bank continues on a path of currency intervention and bond purchases. Further examples of divergence are likely to emerge as developing macro data creates more daylight between those that are able to recover quickly and those that will lag behind thus requiring a more dovish policy framework. The effect on currency pairs will be more pronounced if individual recoveries are unsynchronised, fractured and localised.

Whether you subscribe to the V-shaped recovery theory or not, there is always the question of how economies will recover considering that debt levels are likely to be capped from now on as precautionary measures are put in place for the future. In this scenario it could be argued that future growth rates will struggle to match growth rates of the past because credit will be harder to obtain and forthcoming financial regulation will restrict the riskier, more profitable practises that lay the foundations of the financial crisis. The same practises generated a large portion of economic growth so as they are curbed, what will replace them?

The dilemma is a tough one; to create growth consumers and businesses must spend although spending requires more borrowing (more debt). Companies as well as individuals are currently in the business of saving money because of the trauma just passed and the uncertainty going forward. Nobody is interested in taking on debt if their job security is low for example or to invest in a new business venture if there is limited potential to profit from it – the current economic crisis has not only created substantial losses but has also left a retainer on the recovery in the form of a psychological unwillingness to return to old habits. The trouble is that those same old



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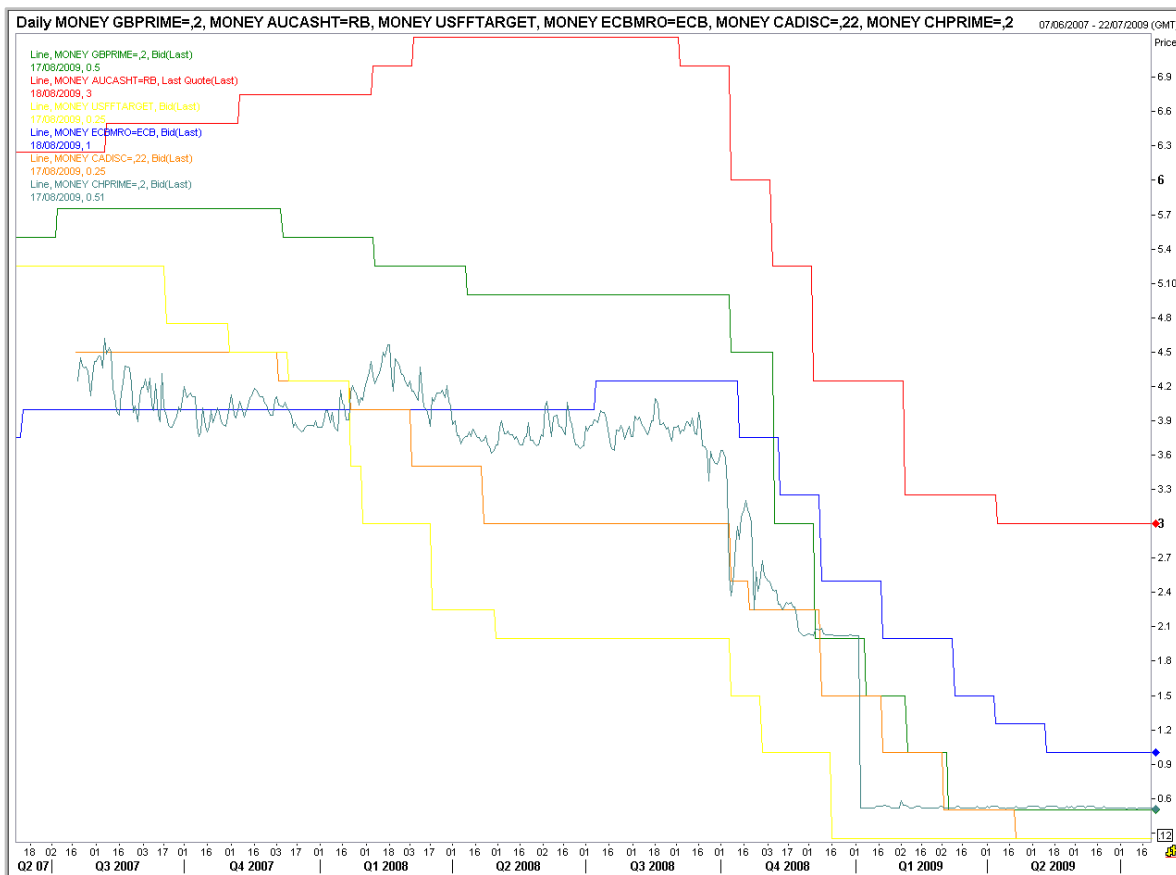
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habits are now needed but to a more measured extent. However, convincing individuals that they should take risks in such an uncertain environment will require more than just low interest rates. Central banks are seemingly trying to remove uncertainty and doubt away from the playing field in order for confidence to return, the key question is how much certainty can one sell in such an uncertain world? Not only the perception of economic reality, but economic reality itself is changing so quickly that policymakers are having trouble carrying out their remits amidst a barrage of conflicting indicators. Somewhat strangely, policymakers and politicians are convinced that no one could have foreseen such an unprecedented economic crisis and yet they are able to see an unprecedented economic recovery.

Chart showing interest rate paths of UK, US, EU, Canada, Switzerland and Australia since Q2 2007.



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