

A Strange New World

Late last month, the Bank of Japan resorted to negative interest rates in a bid to push up inflation and growth: an unstated objective may well have been to depreciate the yen. If so, the move failed: after the introduction of negative interest rates, the yen fell sharply, only to strengthen even more over the next couple of weeks. Incidentally, so did the euro. Sweden has the world's highest negative rate, but the currency is strong – and the central bank has recently taken powers to intervene in the market to halt the currency's appreciation.

The correlation between higher interest rates and appreciating currencies has never been very strong. When many traders in the market so believe, that creates a momentum which becomes its own logic; on economic fundamentals, low inflation (of which low interest rate is a sign), should lead to appreciation of the currency against higher inflation currencies. The surest way of guiding exchange rates remains intervention in the currency market, as the People's Bank of China is showing.

Several countries in Europe as well as Japan are today in a negative interest rate regime. I do not recall a parallel to this strange world of negative interest rates over the last 6/7 decades. One major question is how negative interest rates would affect the profitability of the banking system: nobody has a clear idea. One immediate impact has been that stock prices of many banks in the advanced industrial countries have fallen sharply (also in India, albeit for a different reason). Nor have the ultra low interest rates led to any spurt in demand for credit, or growth. Could the global economy be facing a recession? Global trade growth, a leading indicator, is flashing a red light.

One also wonders whether the regulatory changes after the 2008 crisis are leading to market illiquidity and, therefore, higher volatility in market prices: it is a fact that the "impact cost" of trades are higher when markets are illiquid. US legislation now prohibits banks from undertaking proprietary trading. This does seem to have reduced the liquidity in the currency and bond markets. In particular, bond funds, especially leveraged ones, could be vulnerable to an increase in redemptions which will force them to sell bonds in an illiquid market. The liquidation of reserves by oil exporters and, on an even bigger scale, by China surely is having an impact on the market liquidity, with few buyers around.

As the last week's testimony by the Federal Reserve Chairman before Congress evidences, the US central bank itself seems confused about the course of monetary policy. A couple of months back, when it raised interest rates, a majority of the members of the rate setting committee were expecting four more increases in the current year. The shape of the yield curve however suggests that the market is not expecting any increase at all! The Federal Reserve Chairman, in her testimony, also seemed to have no clarity about the course of interest rates in 2016. In fact, she said that the central bank is examining the implications of negative interest rates! The standard Dynamic Stochastic General Equilibrium (SDSGE) model seems to be even more useless in the strange new world. (Goldman Sachs, in a major embarrassment, withdrew five of six top trades for 2016 it had identified just six weeks back!)

Coming back to bank stocks, the experience of Deutsche Bank over the last couple of weeks seems to suggest the fragility of Basle III capital charges, when market sentiment changes. Its stock suffered a sharp fall when there were question marks about its ability to pay out the coupon on a contingent convertible bond it had issued some time back. ('Coco's count as additional Tier I capital, since they are automatically converted into equity should the capital ratio fall below the minimum prescribed; the issuing bank also has the right not to pay the coupon in such an eventuality.) DB has more than adequate capital, but this did not prevent a run on its stock. Ultimately, some stability was restored when the regulatory authorities publicly expressed confidence in the bank, and the bank itself undertook to buy back some of the senior debt it had issued. In fact, DB was only one of the banks whose stock fell: many banks in Europe (and indeed the US) suffered the same fate. Clearly, whatever the efficient market theory argues, sentiments like fear, greed and the herd instinct affect market prices much more than "fundamentals".

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